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Transcript Exhibit(s)

Docket #(s): W-01732A-15-0131

W-01303A-15-0131

Exhibit #: S-1-3-9,

EWAZ-1 - EWAZ-4

Willow-1 - Willow-10

R-1 - R-9

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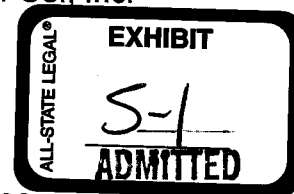
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COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131

Response provided by: Shawn Bradford
Title: VP, Corporate Services, EWAZ

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027



Company Response Number: STF GWB 1.3

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Synergies - Please describe and quantify the value of all positive and negative synergies expected to result from the transfer of Willow Valley to EPCOR. Attach supporting schedules as necessary.

A: The synergies expected to result from this transfer are summarized below:

Service Level: The proximity of EWAZ's other systems will benefit present and future customers within the Willow Valley service area. As the largest provider of utility service in the Mohave County area, EWAZ will be able to provide a level of service and support to customers that meets or exceeds existing service levels.

Response Time: EWAZ's regional presence in Mohave County naturally affords it access to broad in-house utility expertise and resources that can be deployed quickly. In addition, the proximity of EWAZ's other systems provides access to additional operational resources and personnel not currently available to Willow Valley.

Customer Service: Willow Valley customers will be integrated into EWAZ's existing customer service, billing and work order dispatch systems at the time the acquisition is approved. This will provide for a seamless transition into the existing operations in Mohave County.

Maintenance and Operations: EWAZ currently uses various sophisticated maintenance and management systems such as maintenance management, environmental and water quality compliance management, hydraulic modeling, and GIS systems. All these support resources will be deployed in support of the Willow Valley system at the time of closing to provide reliable and high quality service to customers.

Financial Strength: Willow Valley's customers will benefit from EWAZ's financial strength. EWAZ has the financial resources to finance needed infrastructure improvements and future capital and expense requirements, including those that may be required by governmental entities to comply with environmental laws and regulations.

COMPANY:
DOCKET NO:

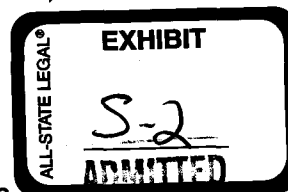
EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
W-01732A-15-0131

Response provided by:
Title:

Shawn Bradford
VP Corporate Services, EWAZ

Address:

2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027



Company Response Number: STF GWB 1.8

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Ratepayer benefits - The Application states "Approval of this Application is in the public interest - it will benefit Willow Valley's customers in several ways and will have no adverse effects."

- a. Please describe and quantify all specific benefits to ratepayers that are expected to result as a result of the transfer of the system to EPCOR. Please describe the methodology used to determine the existence of ratepayer benefits and their valuation.
- b. Please describe the any benefits to be foregone by the ratepayers and expected detriment to the ratepayers if the transfer is not approved.

A: a. Willow Valley customers are expected to benefit from approval of this Application in the ways identified in EWAZ's response to STF GWB 1.3. The benefits are by their nature not quantifiable, and therefore no schedules quantifying the benefits are provided.

- b. Please refer to EWAZ's response to item a. above.

COMPANY:
DOCKET NO:

EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
W-01732A-15-0131

Response provided by: Troy Day
Title: VP Operations, EWAZ

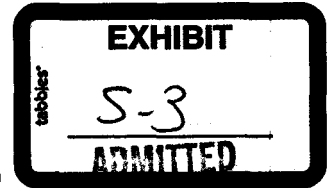
Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

EWAZ Response Number: STF GWB 1.9.a and 1.9.c

Response provided by: Ron Fleming
Title: CEO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Willow Valley Response Number: STF GWB 1.9.b



***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: SIB –

- a. EWAZ - Please indicate whether EPCOR would affect system repairs as provided by the System Improvement Benefit mechanism ("SIB") approved in Decision No. 74364. Please describe in detail the distribution improvement projects that would be planned.
- b. Willow Valley - Please describe if any SIB improvements have been made and reported to the Commission via a SIB filing subsequent to Decision No. 74364. If none or *de minimus* amounts, please explain the reasons that there have been no SIB related repairs to the system.
- c. Please describe any expected modifications to the existing SIB that EPCOR would expect to propose now or in future rate proceedings, and quantify any such impacts to the ratepayers. Attach supporting schedules, as necessary.

- A:
- a. EWAZ intends to implement the SIB eligible projects approved in Decision No. 74364, but will need to become familiar with the operation and service area before developing a detailed capital investment plan for implementation.
 - b. Willow Valley: As stated in Willow Valley Water Company, Inc.'s ("Willow Valley") SIB Status Report filed February 25, 2015 in Docket No. W-01732A-12-0315 to date, Willow Valley has not constructed any SIB

projects. However, Willow Valley took a number of steps to prepare for construction of SIB projects. Willow Valley's Engineering and Construction Staff conducted a thorough on-site data collection effort and concluded the finite details of the project, including the service lateral installation locations for each individual customer. During this on-site effort, Willow Valley's staff contacted and met with the appropriate City and County agencies to discuss the details of the projects, obtain the required construction specifications, and determine the necessary permitting processes. The team compiled this information and hired an engineering firm to produce the detailed construction drawings, which have been completed. Willow Valley anticipated beginning construction on SIB projects in 2016.

With the signing of the Purchase and Sale Agreement between Willow Valley and EWAZ on March 23, 2015, Willow Valley is not currently proceeding with submitting the drawings to contractors to obtain bids and award a contract for construction.

- c. EWAZ will need to have some time operating the system before it can comment on the existing SIB. Once EWAZ has the appropriate operating experience, it will work with ACC Staff to propose any needed changes to the SIB.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131

Response provided by: Ron Fleming
Title: CEO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027



Response provided by: Troy Day
Title: VP Operations, EPCOR

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

EWAZ Response Number: STF GWB 1.10

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Operational concerns - Please describe all operational deficiencies known and each Company's respective plan to correct these deficiencies including estimated costs and dates of completion.

A. Willow Valley: Willow Valley Water Company is in compliance with all operational requirements and there are no "operational" deficiencies.

Since Global Water Resources, Inc. ("Global Water") acquired Willow Valley in 2006, it has made significant investments in improving and modernizing Willow Valley's systems and infrastructure. The first investment was in the addition of modern chlorination systems because chlorination was not in place at the time Willow Valley was acquired. Unfortunately, while chlorination helps ensure water is disinfected and safe to consume, it also created aesthetic issues with the color of the water due to the presence of high concentrations of iron and manganese in the source water, and significant build-up/scale on the interior of the piping system which had formed there over many years due to the lack of proper treatment and maintenance. To remedy these aesthetic issues, Willow Valley invested in a new well and treatment systems that addressed both the water quality and the water appearance, which overtime also allowed the utility to flush all of the deposits out of the distribution system. In addition, Willow Valley invested in upgrading and replacing pumping and piping infrastructure as necessary to improve the reliability and performance of the system and reduce water loss. Finally, Willow Valley replaced all the individual customer meters and equipped them with an advanced metering fixed network system, and installed a SCADA system. These technology systems resulted in many operational improvements and efficiencies, allowing for accurate remote metering, better customer service, and an enhanced capability to

monitor operations ensuring safe, reliable, and economical service to the customers. These efforts have resulted in minimal to no water quality or service level complaints from the Willow Valley customers over the last several years.

Willow Valley's evaluation of the existing infrastructure and need for additional improvements over the next five year planning horizon is contained in the Willow Valley Water Company Water System Engineering Report for System Improvement Benefit (SIB) (revised version submitted to Staff on August 20, 2013, with further corrections on Sept. 3, 2013). A copy is attached.

For further information on the condition of Willow Valley when it was acquired by Global Water in 2006, the improvements made since that time, and the remaining work to be done, please see the following:

- Direct Testimony of Ron Fleming, July 9, 2012, filed with the Rate Application in Docket No. SW-20445A-12-0310, at pages 25-31 and Attachment 3 -- Willow Valley Water Company Water System Master Plan & Preliminary Engineering Report, February 2011. (Copy attached.)
- Hearing Transcript (Volume V) for September 19, 2019 hearing in Dockets W-01212A-12-0309 et al, especially pages 781-792. (Copy attached.)

EWAZ: It is too early for EWAZ to have identified operational deficiencies and a corrective action plan. EWAZ will need to become familiar with the operation and systems prior to making a determination including budget estimates and schedules. EWAZ did conduct an overview assessment of the system in its due diligence efforts, and is aware that in spite of the progress made by Global in addressing water quality concerns during its ownership of the system, further work and investment are required to address areas of particular concern to EWAZ, such as meeting EWAZ's standards of health and safety, maintenance investment, addressing concerns over high levels of non-revenue water, and maintenance of non-operational distribution system valves. At this time it is too early for EWAZ to have developed a detailed capital investment plan for the level of investment required to address the general concerns mentioned above, therefore no cost estimates are provided with this response.

FIGURE 11

5 YEAR SIB - COST SUMMARY TABLE

Year	2014		2015		2016		2017		2018		5-Year Total	
	units	cost	units	cost	units	cost	units	cost	units	cost	units	cost
Pipelines	1,626	\$ 93,630	1,805	\$ 98,669	1,447	\$ 79,124	1,328	\$ 72,668	2,478	\$ 135,711		\$ 479,801
Services	47	\$ 98,674	48	\$ 60,919	39	\$ 50,670	35	\$ 49,598	61	\$ 60,210		\$ 320,070
Meters	-	\$ -	-	\$ -	-		-	\$ -	-	\$ -	-	\$ -
Hydrants	2	\$ 3,941	-	\$ -	-			\$ -	-	\$ -		\$ 3,941
Valves	4	\$ 15,246	3	\$ 11,435	4	\$ 15,246	3	\$ 11,435	5	\$ 19,058		\$ 72,420
Total		\$ 211,491		\$171,022		\$145,040		\$133,701		\$ 214,979		\$ 876,233

FIGURE 13

Company Name: Willow Valley Water Company Inc

Name of System: King Street

WILLOW VALLEY SIB- HISTORICAL WATER LOSS TOTALS

Year	Total Gallon Sold	Total Gallon Pumped	System Water Leakage
2008	91,995	115,312	20.2%
2009	101,495	121,812	16.7%
2010	83,227	104,209	20.1%
2011	68,712	89,824	23.5%
2012	66,696	87,516	23.8%

Source: 2008-2012 Willow Valley Water Company Annual Report

WILLOW VALLEY SIB-PROJECT FUTURE WATER LOSS

Year	SIB Project	Projected Water Loss
2014*	Project 1 Completed	<19%
2015*	Project 2 Completed	<16%
2016*	Project 3 Completed	<14%
2017*	Project 4 Completed	<12%
2018*	Project 5 Completed	<10%

* The reduction in water loss is calculated by taking the realized benefits from replacing the aging infrastructure that has failed a multitude of times in the past and proved to be a major contributor to the water loss recorded for the system. The overall objective of the Willow Valley Water Company is to reduce the overall system water loss to approximately 7%. The 5 Year SIB Project Plan targets the area where infrastructure is most prone to failure and the biggest contributor to water loss. It is estimated that water loss will be at approximately 10% when all five SIB projects have been completed.

EXHIBIT

tabbles

SS

ADMITTED

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH

Chairman

BOB STUMP

Commissioner

BOB BURNS

Commissioner

DOUG LITTLE

Commissioner

TOM FORESE

Commissioner

IN THE MATTER OF THE JOINT)
APPLICATION OF WILLOW VALLEY)
WATER CO., INC. AND EPCOR WATER)
ARIZONA INC. FOR APPROVAL OF THE)
SALE OF ASSETS AND TRANSFER OF)
CERTIFICATE OF CONVENIENCE AND)
NECESSITY)
_____)

DOCKET NOS. W-01732A-15-0131

& W-01303A-15-0131

DIRECT

TESTIMONY

OF

GERALD BECKER

EXECUTIVE CONSULTANT

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

OCTOBER 9, 2015

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EXECUTIVE SUMMARY
WILLOW VALLEY WATER COMPANY & EPCOR WATER ARIZONA, INC.
DOCKET NOS. W-01732A-15-0131 & W-01303A-15-0131

I am presenting Staff's recommendations regarding the transfer of Willow Valley Water Co., Inc. ("Willow Valley") to EPCOR Water Arizona Inc. ("EWAZ") (collectively, the "Applicants").

On April 23, 2015, Willow Valley and EWAZ filed an application to request that the Arizona Corporation Commission ("Commission") approve, pursuant to the Arizona Revised Statutes ("A.R.S.") §§ 40-281, 40-282, 40-285 and Arizona Administrative Code ("A.A.C.") R14-2-402, the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ. The application proposes that EWAZ will pay a price that is 10 percent in excess of the rate base value of Willow Valley. On June 1, 2015, EWAZ filed a supplement to the application to describe the proposed surcharge mechanism to subsequently fund the proposed acquisition premium by seeking a bonus incentive for certain prospective spending on the Willow Valley system.

Staff recommends approval of the transaction subject to the following conditions:

1. That the Commission deny recognition of any acquisition premium that EWAZ pays for Willow Valley,
2. That the Commission deny recognition of any acquisition adjustment or other premium to be applied to expenditures required in the ordinary course of business,
3. Because of the recent Court of Appeals opinion, which set aside the Commission's approval of a System Improvement Benefit ("SIB") mechanism that was materially identical to the SIB approved for Willow Valley in Decision No. 74364, it is necessary to stay the implementation of the SIB mechanism, along with all compliance matters related to the SIB mechanism as set forth in the Plan of Administration if not already done so, pending the outcome of further court proceedings,
4. That EWAZ be put on notice that Willow Valley should work towards balanced capital structure and that a hypothetical capital structure may be deemed in a future rate proceeding if EWAZ fails to do so,
5. In its next full rate case, EWAZ shall include a regulatory liability of \$260,224 to make the ratepayers whole for the effects of the net Accumulated Deferred Income Tax liability that is being retained by Global Water Resources, Inc. EWAZ shall also propose an amortization methodology not to exceed five years for the regulatory liability in its next full rate case, and
6. EWAZ shall continue to comply with all decisions, and more specifically the requirements of Decision No. 74364 which annual requires reporting of the Willow Valley's water losses until such at time as annual water losses is less than 10 percent.

1 **INTRODUCTION**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Gerald Becker. I am an Executive Consultant III employed by the Arizona
4 Corporation Commission ("Commission") in the Utilities Division ("Staff"). My business
5 address is 1200 West Washington Street, Phoenix, Arizona 85007.

6
7 **Q. Briefly describe your responsibilities as an Executive Consultant III.**

8 A. I am responsible for the examination and verification of financial and statistical information
9 included in utility rate applications. In addition, I develop revenue requirements, and prepare
10 written reports, testimonies, and schedules that include Staff recommendations to the
11 Commission. I am also responsible for testifying at formal hearings on these matters.

12
13 **Q. Please describe your educational background and professional experience.**

14 A. I received a Master's of Business Administration with an emphasis in Accounting from Pace
15 University. I am a Certified Public Accountant and a Certified Internal Auditor.

16
17 I have participated in multiple rate, financing and other regulatory proceedings. I attended
18 the National Association of Regulatory Utility Commissioners ("NARUC") Utilities Rate
19 School.

20
21 I began employment with the Commission as a utilities regulatory analyst in April 2006. Prior
22 to joining the Commission, I worked as an Auditor at the Department of Economic Security
23 and Department of Revenue in the Taxpayer Assistance Section. Prior to those jobs, I
24 worked for 15 years as an Auditor, Analyst, Financial Analyst, and Budget Manager at United
25 Illuminating, an investor-owned electric company in New Haven, CT.

26

1 **Q. What is the scope of your testimony in this case?**

2 A. On April 23, 2015, Willow Valley Water Co., Inc. ("Willow Valley") and EPCOR Water
3 Arizona, Inc. ("EWAZ") (collectively, the "Applicants") filed an application to request that
4 the Commission approve, pursuant to the Arizona Revised Statutes ("A.R.S.") §§ 40-281, 40-
5 282, 40-285 and Arizona Administrative Code ("A.A.C.") R14-2-402, the sale of Willow
6 Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N")
7 to EWAZ. The application proposes that EWAZ will pay a price that is in excess of the rate
8 base value of Willow Valley. On June 1, 2015, EWAZ filed a supplement to the application
9 to describe the proposed surcharge mechanism to fund the proposed acquisition premium
10 and to request a bonus incentive on prospective amounts spent on Willow Valley. I am
11 presenting Staff's recommendations regarding the transfer of Willow Valley to EWAZ.

12
13 Willow Valley is a subsidiary of Global Water Resources, Inc. ("Global"). Present rates were
14 set in Docket No. W-01732A-12-0315 which resulted in Decision No. 74364, dated February
15 26, 2014. This decision was the result of a settlement agreement and resulted in a revenue
16 increase of \$404,269, or 57.53 percent, over test year revenues of \$507,537, for total approved
17 revenues of \$1,106,922.¹ This revenue increase is phased in over 2 years beginning in 2015.
18 Decision No. 74364 also approved a System Improvement Benefit ("SIB") mechanism to
19 address, in part, the 23.40 percent water loss in Willow Valley during its test year, along with
20 other necessary repairs to the distribution system.

21
22 **Q. What is the basis of your recommendations?**

23 A. I have reviewed the joint application of EWAZ and Willow Valley whereby EWAZ would
24 acquire certain assets of Willow Valley. I compared the application with the terms and
25 conditions attached to reorganizations approved by the Commission and other regulatory

¹ See Decision No. 74364, Settlement Schedule A-1, for Willow Valley.

1 bodies to ensure adequate protections exist for the ratepayers along with evaluating the
2 amount of benefits that would accrue to the ratepayers as a result of the proposed transfer of
3 assets.

4
5 **SUMMARY OF TESTIMONY AND RECOMMENDATIONS**

6 **Q. Please summarize Staff's recommendations.**

7 **A.** Staff recommends approval of the transfer subject to certain conditions which are intended to
8 benefit and protect ratepayers. These conditions include:

- 9
- 10 1. That the Commission deny recognition of any acquisition premium that it pays for
11 Willow Valley,
 - 12 2. That the Commission deny recognition of any acquisition adjustment or other
13 premium to be applied to expenditures required in the ordinary course of business,
14 Because of the recent Court of Appeals opinion, which set aside the Commission's
15 approval of a SIB mechanism that was materially identical to the SIB approved for
16 Willow Valley in Decision No. 74364, it is necessary to stay the implementation of the
17 SIB mechanism, along with all compliance matters related to the SIB mechanism as
18 set forth in the Plan of Administration if not already done so, pending the outcome of
19 further court proceedings,
 - 20 3. That EWAZ be put on notice that Willow Valley should work towards balanced
21 capital structure and that a hypothetical capital structure may be deemed in a future
22 rate proceeding if EWAZ fails to do so,
 - 23 4. In its next full rate case, EWAZ shall include a regulatory liability of \$260,224 to make
24 the ratepayers whole for the effects of the net Accumulated Deferred Income Tax
25 liability that is being retained by Global. EWAZ shall also propose an amortization

1 methodology not to exceed five years for the regulatory liability in its next full rate
2 case, and

- 3 5. EWAZ shall continue to comply with all decisions, and more specifically the
4 requirements of Decision No. 74364 which annual requires reporting of the Willow
5 Valley's water losses until such at time as annual water losses is less than 10 percent.

6
7 **ACQUISITION PREMIUM / ACQUISITION ADJUSTMENT**

8 **Q. Is the Company proposing an acquisition premium?**

9 A. Yes. The Companies are proposing a ten percent acquisition premium of \$226,803 which
10 they claim to represent 10 percent of Willow Valley's rate base.

11
12 **Q. Does Staff support the proposed acquisition premium in this proceeding?**

13 A. No. The proposed transfer of Willow Valley from Global to EWAZ does not warrant
14 payment of or regulatory recognition of an acquisition premium. Global, Willow Valley's
15 parent, is a Class A, well capitalized utility company with access to the operational expertise as
16 well as the capital necessary to own and operate Willow Valley. Accordingly, a transfer of
17 ownership does not represent significant benefits to the ratepayers of Willow Valley.

18
19 On February 26, 2014, Willow Valley was granted a SIB in Decision No. 74364 due to its
20 aging infrastructure which has undoubtedly contributed to a 23.40 percent water loss as noted
21 in Willow Valley's most recent rate proceeding. Willow Valley has not undertaken SIB
22 eligible necessary capital replacements to the system. In fact, the water loss has risen to 26.1
23 percent.² Due to the state of the infrastructure at Willow Valley and Global's failure to
24 mitigate its water losses, Staff recommends that the Commission be mindful not to create an
25 incentive for those who fail to maintain water systems to propose to sell those systems at an

² See Compliance filing of Willow Valley Water Company in Docket No. W-01732A-15-0131, May 29, 2015.

1 amount in excess of its rate base value. Further, the applicants have not presented any
2 evidence that the "goodwill" or "going concern value" in excess of the book value is of any
3 benefit to the ratepayers. Further, and in response to Residential Utility Consumer Office
4 ("RUCO") data request 2.05, Willow Valley states that there are no present problems with the
5 water quality or provision of service that would be addressed by the proposed transfer.
6

7 **Q. Does Staff agree with the Companies' calculation of the acquisition premium that**
8 **they are proposing?**

9 A. No. The Companies propose an acquisition premium equal to 10 percent of the EWAZ's re-
10 calculation of rate base which excludes certain components customarily included in a rate
11 base calculation. The amounts proposed to be excluded are Accumulated Deferred Income
12 Tax ("ADIT") Credit of \$293,862, an ADIT Debit of \$33,638,³ and Customer Deposits of
13 \$31,898, the net of which is a misstatement of Willow Valley's rate base in the amount of
14 \$292,122. By excluding these items, the Companies overstate the value of the Willow Valley
15 and understate the proposed acquisition premium by \$335,532, as discussed and shown
16 below.
17

18 **Q. Please describe and provide the Company's calculation of the value being transferred,**
19 **the purchase price, and the proposed acquisition premium.**

20 A. In response to Staff data request GWB 1.1, EWAZ used its rate base methodology to
21 determine a rate base of \$2,268,031, plus a 10 percent acquisition premium, to support the
22 purchase price of \$2,494,834 as shown below:
23

³ Net ADIT is equal to \$260,224.

Descriptions	EPCOR Purchase Price Calculation <u>as of 12-31-2014</u>	
Utility Plant in Service	\$5,146,109	
CWIP	<u>\$19,767</u>	
Total PP&E	\$5,165,876	
Accumulated Depreciation	<u>(\$2,369,499)</u>	
Gross Plant	\$2,796,377	(more correctly defined as 'net plant')
AIAC	<u>(\$69,347)</u>	
CIAC	<u>\$458,999</u>	
Net Rate Base	\$2,268,031	
With 10% Acquisition Premium	<u>1.10</u>	(or \$226,803 acquisition premium)
Purchase Price	\$2,494,834	

1
2 **Q. Does Staff agree with the Applicants' rate base calculation shown above?**

3 A. No. In response to Staff data request GWB 1.6, Global, the parent of Willow Valley,
4 provided a schedule of its rate base as of December 31, 2011⁴, totaling \$2,278,955, and the
5 rate base as of December 31, 2014, totaling \$1,964,397, as shown below.
6

⁴ December 31, 2011, was the end of the test year in Willow Valley's most recent rate case in Docket No. W-01732A-12-0315, Decision No. 74364.

		12/31/2011	12/31/2014
1	Plant in Service	\$ 5,033,102	\$ 5,168,988
2	Less: Accumulated Depreciation	(1,742,556)	(2,384,123)
3	Net Plant in Service	<u>\$ 3,290,546</u>	<u>\$ 2,784,864</u>
	LESS:		
4	Contributions in Aid of Construction (CAIC)	\$	\$ 537,430
5	Less: Accumulated Amortization		(78,432)
6	Net CAIC		<u>458,999</u>
7	Advances in Aid of Construction (AIAC)	610,760	69,347
8	Imputed Reg AIAC		
9	Imputed Reg CAIC		
10	Accumulated Deferred Income Tax Credits	391,114	293,862
11	Customer Meter Deposits	36,233	31,898
	ADD:		
12	Accumulated Deferred Income Tax Debits	26,516	33,638
13	Cash Working Capital		
14	Purchase Wastewater Treatment Charges		
	Original Cost Rate Base	<u>2,278,955</u>	<u>1,964,397</u>

Q. Please identify and discuss the differences in the rate base calculations.

A. As indicated above and in its response to Staff data request GWB 1.1, the EWAZ indicates net rate base of \$2,268,031, as compared with the net rate base of \$1,964,397 provided in response to Staff data request GWB 1.6, for a difference of \$303,634. Most of this (\$292,122) is due to the omission of ADIT amounts with net amount of \$260,224, plus Customer Deposits of \$31,898, for a total of \$292,122 in EWAZ's calculation of the rate base provided in response to Staff data request GWB 1.1. There is also an unexplained difference of \$11,513⁵ in the net plant amounts provided by EWAZ due to different amounts being provided in EWAZ's response to GWB1.1 and the response of Global to Staff data Request GWB 1.6. Adding the \$292,122 difference for ADIT and Customer Deposit to the \$11,513 unreconciled difference for the plant balances equals the difference of \$303,634.

⁵ In EWAZ's response to Staff data request GWB1.1, the Company indicates net plant of \$2,796,377, as compared with the net plant of \$2,784,864 in Global's response to Staff data request GWB1.6, for a difference of \$11,513.

1 The failure to recognize the ADIT (which represents funds already provided by customers)
2 and correct plant balances means that the proposed acquisition premium of \$226,803 is
3 understated by \$335,532, for total proposed acquisition premium of \$562,335, as shown
4 below. In response to a RUCO data request, Willow Valley will refund customer deposits to
5 its customers after the transfer. Accordingly, the acquisition premium would be calculated
6 based on a comparison of the adjusted rate bases of \$1,932,499 (\$1,964,397 less \$31,898
7 customer deposits) with the proposed price of \$2,494,834, for an acquisition premium of
8 \$562,335, or 29.1 percent of the adjusted rate base of \$1,932,499⁶.

10	Purchase Price, per GWB1.1	\$2,494,834
11	Rate Base, Per GWB 1.6	\$1,964,397
12	Less Customer Deposits	<u>\$ 31,898</u>
13	Adjusted Rate Base	\$1,932,499
14	Acquisition Premium	\$ 562,335 or 29.1 percent
15	Acquisition Premium, per applicants	<u>\$ 226,803</u>
16	Understatement of Acquisition Premium	\$ 335,532

17
18 **Q. Please explain the reasons to use the corrected rate base to determine the proposed**
19 **acquisition premium.**

20 A. Although EWAZ's calculation provided in response to Staff data request GWB 1.1 may
21 reflect the terms of the asset purchase agreement between the Applicants, such calculation
22 would deprive the ratepayers of valuable ratepayer benefits. First, the exclusion of ADIT
23 deprives ratepayers of the benefits of amounts provided to the regulated utility through
24 income tax expense but not yet remitted to the taxing authorities. Such amounts represent a
25 source of non-investor supplied capital to the regulated entity and are properly included in

⁶ Response of Global Water Resources, Inc. to Staff data request GWB1.6 indicated a rate base of \$1,964,397, less customer meter deposits of \$31,898, for a net of \$1,932,499.

1 rate base calculations. Second, customer deposits also represent non-investor funds supplied
2 to the regulated entity and which should also be reflected in the rate base calculation in this
3 proceeding as well as in future rate cases. In response to RUCO data request 2.02, the
4 Applicants state that customer deposits will be returned to customers upon closing the
5 transaction. The logistical and operational concern involves the repayment of those monies
6 to ratepayers and the increased risk of bad debt expense that may accompany that practice.
7 In the past judgment of Willow Valley, certain customers were required to post security
8 deposits to guarantee payment of bills. Failure to retain those amounts puts the rest of the
9 customers at greater risk of uncollectible amounts which would be absorbed by the other
10 customers in a future rate case. Third, the correct net plant balances should be used in the
11 calculation of the values to be transferred as well as in the calculation of any acquisition
12 premium that might be approved in this proceeding.

13
14 **Q. What does Staff recommend regarding the ADIT?**

15 **A.** If the proposed transfer is approved, Staff recommends that EWAZ establish a regulatory
16 liability in its next full rate case in the amount of \$260,224 to provide benefits to the
17 ratepayers who would have benefitted if the net ADIT balance had been transferred to the
18 buyer. A net ADIT liability represents income taxes previously paid by the ratepayers but not
19 yet remitted by the utility company, and in effect, is a source of non-investor capital that is
20 recognized in rate base calculations and result in a reduction to the rate base. The proposal
21 not to transfer the ADIT balances to the buyer should be accepted only if the ratepayers are
22 made whole for rate base reduction associated with the net ADIT liability by establishing a
23 regulatory liability in the next full rate case. EWAZ should also propose a methodology to
24 amortize the regulatory liability in its next full rate case.

25

1 **Q. What does Staff recommend regarding the acquisition premium?**

2 A. In response to Staff data requests, EWAZ was unable to provide a quantification of any
3 benefits expected to accrue to the ratepayers as a result of the transfer of these assets to them.
4 Accordingly, there is no justification to support an acquisition premium to be borne by the
5 ratepayers.
6

7 **Q. Are there other benefits that are not being shared with the ratepayers?**

8 A. Yes. The transfer of assets means that those assets will now be supported by capital from
9 EWAZ which has a capital structure that is more favorable to the ratepayers (i.e., less equity).
10 This is based on a comparison of the capital structure approved in Willow Valley's most
11 recent rate case in Docket No. W-01732A-15-0131 and the capital structure proposed by
12 EWAZ in its most recent rate case (WS-01303A-14-0010). Staff has recalculated the revenue
13 requirements for Willow Valley by supplanting Willow Valley's capital structure with
14 EWAZ's⁷ and found this could result in a reduction to the revenue requirements of
15 approximately \$29,000 per year. This potential reduction is a ratepayer benefit that should
16 accrue to the ratepayers to reduce the \$404,269, or 57.53 percent increase approved in Willow
17 Valley's most recent rate case. This reduction represents monies available to EWAZ to make
18 necessary improvements to the system, and further precludes the need for any extraordinary
19 ratemaking treatment of monies that need to be expended on Willow Valley. The capital
20 structure will not align until EWAZ's next rate case concludes.
21

⁷ Revenue requirements recalculated for Willow Valley using a weighted average cost of equity of 3.82 percent and a weighted average cost of debt of 2.56 percent, for a total cost of capital of 6.38 percent, per Decision No. 75268 in Docket No. WS-01303A-14-0010. This would result in a required revenue increase of \$375,537 as compared with the increase of \$404,269 in Decision No. 74364 in Docket No. W-01732-12-0315, a difference of \$28,732.

1 **Q. Have the Companies identified and quantified any benefits in support of the**
2 **proposed acquisition premium?**

3 **A. No.** In its response to Staff data request GWB 1.3, EWAZ is unable to identify and quantify
4 the value of specific quantifiable benefits for the ratepayers for approving the transaction.
5 EWAZ provides only general statements regarding its ability to provide service, and EWAZ
6 does not identify and assign a value to any specific improvement that will benefit the
7 ratepayers of Willow Valley. Further, in response to RUCO data request 2.05, Willow Valley
8 states that it is presently providing safe and reliable drinking water, and this would suggest
9 that there are no present deficiencies that would be corrected only by the transfer.

10

11 **Q. In addition to an acquisition premium, is EWAZ proposing an acquisition**
12 **adjustment?**

13 **A. Yes,** in addition to an acquisition premium based on the excess of the purchase price over its
14 incomplete calculation of Willow Valley's book value discussed above, EWAZ is proposing
15 an acquisition adjustment on prospective capital investments to be made to the system, as
16 discussed in its supplement of June 1, 2015 to the application. EWAZ proposes that it
17 should receive a bonus of 10 to 20 percent over the actual cost of investments that will be
18 made to the system. In its application, EWAZ estimates to spend approximately \$1,000,000
19 over 5 years for projects not outlined in the existing SIB, and these projects might include,

20

21 1) a system interconnect between the King Street and Lake Cimarron areas of the
22 existing Willow Valley system to provide operational flexibility and redundancy,
23 2) replacement of system valves that are currently non-operational, 3) a more
24 robust backwash effluent discharge retention system to prevent leaching into the
25 aquifer, 4) necessary maintenance of three storage tanks, and 5) replacement or
26 repair of failed flow and backwash meters and other infrastructure projects.⁸

27

⁸ See Supplement to Application, dated June 1, 2015, 5 at 1-7.

1 **Q. What are Staff's comments regarding the proposed acquisition adjustment?**

2 A. First, the proposed underlying spending plan does not warrant special ratemaking treatment.
3 Maintenance of storage tanks are typically considered as part of a utility's routine operating
4 and maintenance expenses. Moreover, expenditures necessary to keep a utility in good repair
5 are part of the normal course of utility operations and accordingly do not warrant a premium
6 to be paid to a utility for meeting its basic obligations regarding the provision of service.
7 EWAZ has not identified any specific operational deficiency that would be solved by
8 interconnecting Willow Valley's two areas, each of which already has multiple wells that can
9 be used as sources of production⁹. Accordingly, Staff recommends the denial of the
10 acquisition adjustment.

11
12 Further, Staff would note that the revenue calculations on the bonus to be applied to the
13 EWAZ's investment¹⁰ reflects EWAZ's cost of capital, not the cost of capital approved in
14 Decision No. 74364 for the most recent Willow Valley case in Docket No. W-01732A-12-
15 0315, and the stated expected monthly cost to the ratepayers reflect the bonus only and not
16 the totality of the investment. The Company's stated bill impact of \$1.21, or 2.22 percent¹¹
17 per month per customers supports only the bonus proposed by the Company. The
18 Company's proposal would result in a total increase to the bill of a customer using 5,000
19 gallons per month of \$7.27, or 16.78 percent, from \$43.33 to \$50.60. This increase is in
20 addition to the increase approved in Decision No. 74364 which increases the bill of a
21 customer using 5,000 gallons per month by \$14.82, or 52.0 percent, from \$28.51 to \$43.33.

⁹ See Staff Engineering Testimony of Jian Liu filed on July 8, 2013 in Docket No W-01732A-12-0315.

¹⁰ See Supplement to Application dated June 1, 2015, 4 at 17-23. i.e. required Annual Operating Income Produced of \$6,740 on a \$100,000 Authorized Incentive, for an rate of return of 6.74 percent, as compared with 7.50 percent rate of return approved in Decision No. 74568 in Docket No. W-01732A-12-0315.

¹¹ EWAZ incorrectly used \$54.66 for its monthly bill to a customer using 5,000 gallons per month. The correct bill is \$43.33 to reflect the "CRT" reduction of \$11.33 from the unadjusted amount of \$54.66, for a corrected percentage increase of 2.79 percent (\$1.21 divided by \$43.33). In Docket No W-01732A-12-0315, the Commission approved a Conservation Rebate Threshold or "CRT" providing a 50 percent discount applied to the volumetric component of customers' bills for all bills less than or equal to 6,000 gallons per month.

1 The combined impact of the recent rate decision and EWAZ's proposal in the instant
2 proceeding would increase of a customer using 5,000 gallons per month by \$22.09, or 77.48
3 percent, from \$28.51 to \$50.60. The overall increase of \$22.09, or 77.48 percent, is
4 significantly higher than the \$1.21 per month represented by the Company.

5
6 **DUE DILIGENCE WORKPAPERS**

7 **Q. Did Staff request access to EWAZ's due diligence workpapers related to its purchase**
8 **of Willow Valley?**

9 A. Yes. In Staff data request GWB 1.1 e.¹², Staff requested access to the EWAZ's due diligence
10 workpapers supporting its decision to buy Willow Valley¹³. In addition the general objections
11 to all of Staff's data requests,¹⁴ EWAZ responded,

12
13 "EWAZ objects to STF GWB 1.1e to the extent that it seeks information that is
14 not reasonably calculated to lead to the discovery of admissible evidence.
15 EWAZ further objects to STF GWB 1.1e to the extent that it seeks information
16 protected by the attorney-client privilege, the work-product doctrine or any other
17 privilege recognized under law. EWAZ also objects to STF GWB 1.1e to the
18 extent that it seeks highly confidential business information or trade secrets.

19
20 However, EWAZ subsequently reconsidered Staff's request and provided Staff with access to
21 its due diligence workpapers. Based on its review of those workpapers, Staff has no concerns
22 specific to the Company's due diligence.

23

¹² See Attachment 1, Staff data request GWB1.1

¹³ Staff has requested and was provided access to the due diligence workpapers in other proceedings, such as the recent acquisition of UNS Energy by Fortis, Inc. in Docket Nos. E-01933A-14-0011 and E-04230A-14-0011.

¹⁴ See Attachment 2, EWAZ's General Objections To All Data Requests

SYSTEM IMPROVEMENT BENEFIT MECHANISM

Q. What is the status of the SIB that was awarded to Willow Valley Decision No. 74364?

A. Decision No. 74364 awarded a SIB to Willow Valley to address its aging infrastructure and indirectly, its 23.40 percent water loss. Accordingly to the compliance report filed on May 29, 2015, the 12 month water loss for Willow Valley has increased to 26.1 percent. The compliance report further states that Willow Valley has not implemented any SIB related repairs, prior to the SIB being stayed by the AZ Court of Appeals.

Staff recommends that because of the recent Court of Appeals opinion, which set aside the Commission's approval of a SIB mechanism that was materially identical to the SIB approved for Willow Valley in Decision No. 74364, it is appropriate to stay the implementation of the SIB mechanism, along with all compliance matters related to the SIB mechanism as set forth in the Plan of Administration, pending the outcome of further court proceedings. EWAZ should however file annual reports detailing Willow Valley's current water loss until such time when the annual water losses are less than 10 percent.

CAPITAL STRUCTURE

Q. Please describe the proposed funding of the transaction.

A. The application states that EWAZ will fund the purchase of Willow Valley in cash. There is no indication of any debt to be assumed or executed, and the application does not discuss the specific capital structure that will arise as a result of the transaction.

Q. Does Staff have any concerns regarding the resulting capital structure?

A. Yes. Staff is concerned the description of the transaction might result in EWAZ taking the position that Willow Valley is supported by 100 percent equity in a future rate case. In Staff data request GWB 1.7, Staff attempted to determine the capital structure that EWAZ is

1 expecting to exist for Willow Valley if the proposed transaction is approved by the
2 Commission:

3
4 Q. Please explain the capital structure that would result if (from) the proposed
5 transfer to EPCOR.

6
7 EWAZ declined to provide a definite answer, stating in part,

8
9 A. "EWAZ objects to DR GWB 1.7 to the extent that it is not reasonably
10 calculated to lead to the discovery of admissible evidence. EPCOR also
11 objects to DR GWB 1.7 to the extent that it is vague and ambiguous and calls
12 for speculation..."

13
14 Staff recommends that the Commission put EWAZ on notice that Willow Valley should
15 work towards having a balanced capital structure and that utilization of a hypothetical capital
16 structure may be recommended in a future rate proceeding if EWAZ fails to do so. Staff
17 assumes Willow Valley's capital structure will be identical to that of EWAZ's other districts.

18
19 **RECOMMENDATIONS**

20 **Q. Based on the above, what is Staff recommending?**

21 A. Staff recommends approval of the transaction subject to the following conditions:

- 22
23 1. That EWAZ shall refrain from seeking rate recognition of any acquisition premium
24 that it pays for Willow Valley,
25 2. That EWAZ shall refrain from seeking rate recognition of any acquisition adjustment
26 or other premium to be applied to expenditures required in the ordinary course of
27 business,
28 3. Because of the recent Court of Appeals opinion, which set aside the Commission's
29 approval of a SIB mechanism that was materially identical to the SIB approved for

1 Willow Valley in Decision No. 74364, it is appropriate to stay the implementation of
2 the SIB mechanism, along with all compliance matters related to the SIB mechanism
3 as set forth in the Plan of Administration, pending the outcome of further court
4 proceedings,

5 4. That EWAZ be put on notice that Willow Valley should work towards balanced
6 capital structure and that a hypothetical capital structure may be deemed in a future
7 rate proceeding if EWAZ fails to do so,

8 5. In its next full rate case, EWAZ shall include a regulatory liability of \$260,224 to make
9 the ratepayers whole for the effects of the net Accumulated Deferred Income Tax
10 liability that is being retained by Global. EWAZ shall also propose an amortization
11 methodology not to exceed five years for the regulatory liability in its next full rate
12 case, and

13 6. EWAZ shall continue to comply with all decisions, and more specifically the
14 requirements of Decision No. 74364 which annual requires reporting of the Willow
15 Valley's water losses until such at time as annual water losses is less than 10 percent.
16

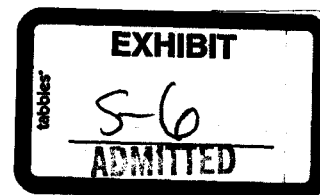
17 **Q. Does this conclude your direct testimony?**

18 **A. Yes, it does.**

**EPCOR WATER ARIZONA, INC.'S GENERAL OBJECTIONS
TO STAFF'S FIRST SET OF DATA REQUESTS
DOCKET NO. W-01732A-15-0131**

GENERAL OBJECTIONS TO ALL DATA REQUESTS

1. Epcor Water Arizona, Inc. ("EWAZ") objects to each Request to the extent it seeks information subject to the attorney-client privilege, work product doctrine or any other privilege recognized by the State of Arizona. In responding to these Requests, EWAZ preserves all such privileges.
2. EWAZ objects to each Request to the extent that it is unreasonably burdensome, overly broad and/or not reasonably calculated to lead to the discovery of admissible evidence.
3. EWAZ objects to each Request to the extent it calls for speculation.
4. EWAZ objects to each definition and/or instruction to the extent it purports to abrogate any of EWAZ's rights, or adds to any of EWAZ's obligations under, the Arizona Rules of Civil Procedure or the Commission's Rules.
5. EWAZ objects to each Request to the extent that it is overly broad, unduly burdensome and imposes any burden not expressly permitted under the Commission's Rules or the Arizona Rules of Civil Procedure.
6. EWAZ objects to each Request to the extent that the information requested constitutes "trade secrets" that are privileged under the Arizona Uniform Trade Secrets Act, Ariz. Rev. Stat. § 44-401, et. seq. (2003).
7. EWAZ objects to each Request to the extent it seeks information not within EWAZ's possession, control, or custody and/or to the extent the Requests ask EWAZ to provide information that it does not maintain in the ordinary course of business.
8. EWAZ objects to each Request to the extent it calls for a legal conclusion.
9. EWAZ reserves the right to supplement or amend its objections and responses as necessary.



BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH

Chairman

BOB STUMP

Commissioner

BOB BURNS

Commissioner

DOUG LITTLE

Commissioner

TOM FORESE

Commissioner

IN THE MATTER OF THE JOINT
APPLICATION OF WILLOW VALLEY
WATER CO., INC. AND EPCOR WATER
ARIZONA INC. FOR APPROVAL OF THE
DALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY.

DOCKET NO. W-01732A-15-0131
W-01303A-15-0131

SURREBUTTAL

TESTIMONY

OF

DARRON CARLSON

PUBLIC UTILITIES ANALYST MANAGER

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

NOVEMBER 13, 2015

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EXECUTIVE SUMMARY
WILLOW VALLEY WATER CO., INC. & EPCOR WATER ARIZONA, INC.
DOCKET NOS. W-01732A-15-0131 & W-01303A-15-0131

I am adopting the direct testimony of Gerald Becker as my own. I am filing surrebuttal testimony to 1) withdraw one of Staff's recommendations from direct testimony and 2) respond to the Applicants' various witness' rebuttal testimony.

Staff recommends:

1. That the Commission deny recognition of any acquisition premium that EPCOR Water Arizona, Inc. ("EWAZ") pays for Willow Valley Water Co., Inc. ("Willow Valley"),
2. That the Commission deny recognition of any acquisition adjustment or other premium to be applied to capital expenditures required in the ordinary course of business,
3. That EWAZ be put on notice that Willow Valley should work towards a balanced capital structure and that a hypothetical capital structure may be deemed appropriate in a future rate proceeding if EWAZ fails to do so,
4. That EWAZ shall continue to comply with all prior decisions, and more specifically the requirements of Decision No. 74364 which requires annual reporting of the Willow Valley water losses until such time as annual water losses are less than 10 percent.

1 **INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. My name is Darron Carlson. My business address is 1200 West Washington Street, Phoenix,
4 Arizona 85007.

5
6 **Q. By whom are you employed and in what capacity?**

7 A. I am employed by the Utilities Division ("Staff") of the Arizona Corporation Commission
8 ("ACC" or "Commission") as a Public Utilities Analyst Manager.

9
10 **Q. How long have you been employed with the Utilities Division?**

11 A. I have been employed by the Utilities Division since September of 1991.

12
13 **Q. Please describe your educational background and professional experience.**

14 A. I hold a Bachelor of Arts degree in both Accounting and Business Management from
15 Northeastern Illinois University in Chicago, Illinois.

16
17 I have participated in quite a number of seminars and workshops related to utility rate-
18 making, cost of capital, income taxes, and similar issues. These have been sponsored by
19 organizations such as the National Association of Regulatory Utility Commissioners
20 ("NARUC"), Duke University, Florida State University, Michigan State University, New
21 Mexico State University, and various other organizations.

22
23 **Q. Briefly describe your responsibilities as a Public Utilities Analyst Manager.**

24 A. In my capacity as a Public Utilities Analyst Manager, I supervise analysts who examine, verify,
25 and analyze utilities' statistical, financial, and other information. These analysts write reports
26 and/or testimonies analyzing proposed mergers, acquisitions, asset sales, financings, rate

1 cases, and other matters in which they make recommendations to the Commission. I provide
2 support and guidance along with reviewing and editing the work products. I also perform
3 analysis as needed on special projects. Additionally, I provide expert testimony at formal
4 hearings. Finally, I assist Staff members during formal hearings and supervise responsive
5 testimonies, as needed, during the hearing process.

6
7 **PURPOSE OF TESTIMONY**

8 **Q. What is the scope of your testimony in this case?**

9 A. I am adopting the direct testimony of Staff witness, Gerald Becker, as my own. In addition,
10 in my surrebuttal testimony, I withdraw one of Staff's recommendations in Staff's direct
11 testimony. Further, I respond where necessary, to the rebuttal testimonies filed by Ron
12 Fleming and Paul Walker on behalf of Willow Valley Water Co., Inc. ("Willow Valley") and
13 Shawn Bradford and Sarah Mahler on behalf of EPCOR Water Arizona Inc. ("EWAZ")
14 (collectively, the "Applicants"). I am also presenting Staff's revised recommendations
15 regarding the transfer of Willow Valley to EWAZ.

16
17 **Q. Do you attempt to address every issue raised by the Applicant's various witnesses in
18 its rebuttal testimonies?**

19 A. No. My silence on any particular issue raised in the Applicant's rebuttal testimonies does not
20 indicate that Staff agrees with the Applicant's rebuttal position on that issue. Rather, I rely on
21 my direct testimony unless modified by this surrebuttal testimony.

22
23 **SUMMARY OF RECOMMENDATIONS**

24 **Q. Please summarize Staff's recommendations.**

25 A. Staff recommends approval of the transfer subject to certain conditions which Staff believes
26 to be in the public interest. These conditions include:

- 1 1. That the Commission deny recognition of any acquisition premium that EWAZ pays
- 2 for Willow Valley,
- 3 2. That the Commission deny recognition of any acquisition adjustment or other
- 4 premium to be applied to capital expenditures required in the ordinary course of
- 5 business,
- 6 3. That EWAZ be put on notice that Willow Valley should work towards a balanced
- 7 capital structure and that a hypothetical capital structure may be deemed appropriate
- 8 in a future rate proceeding if EWAZ fails to do so,
- 9 4. That EWAZ shall continue to comply with all decisions, and more specifically the
- 10 requirements of Decision No. 74364 which requires annual reporting of the Willow
- 11 Valley water losses until such time as annual water losses are less than 10 percent.

12
13 **Q. How do the above recommendations compare to the recommendations reflected in**
14 **Staff's direct testimony?**

15 A. The recommendations listed above are virtually identical to the recommendations reflected in
16 Staff's direct testimony except that Staff had listed six recommendations in its direct
17 testimony and has withdrawn two (originally listed as number 3 and 5 in direct testimony) in
18 its surrebuttal testimony. Recommendation 3 concerning SIB was addressed by the
19 Commission in the interim of filing Staff direct and surrebuttal testimonies.

20
21 **Q. Why has Staff withdrawn recommendation 5?**

22 A. This recommendation was in regard to the creation of a regulatory liability (chargeable to
23 EWAZ) to replace the accumulated deferred income taxes that serve to reduce rate base that
24 will disappear in the sales transaction. This will have the effect of increasing the rate base by
25 approximately \$260,000 after the sales transaction is completed. Staff believed that creating
26 the liability would leave the rate payers whole and unaffected by the sales transaction.

1 **Q. Then why does Staff now want to withdraw the recommendation?**

2 A. Staff has now concluded that this type of regulatory action may be inconsistent with the
3 Internal Revenue Service's Normalization rules. If the Commission were to approve the
4 regulatory liability, EWAZ could find itself out of compliance with the Normalization rule
5 and could lose its ability to claim accelerated depreciation in the future on all of its
6 depreciable utility plant in Arizona. This could present a very serious situation for EWAZ
7 and all of its ratepayers in Arizona.

8
9 **RESPONSE TO REBUTTAL TESTIMONIES**

10 **Q. Have you reviewed the rebuttal testimony of Willow Valley witness, Ron Fleming?**

11 A. Yes I have. The only comments I have are that it appears that Global (Willow Valley's
12 current parent) will likely suffer a capital loss on this sales transaction. Further, the extensive
13 efforts put forward by Global would indicate that Willow Valley while needing a lot of
14 refurbishment is certainly not a "distressed" utility. That is to say Global can fund and make
15 improvements and properly operate the system.

16
17 **Q. Have you reviewed the rebuttal testimony of Willow Valley witness, Paul Walker?**

18 A. Yes I have. While Mr. Walker is generally correct in his academic discussion of utility
19 consolidation, the fact is most consolidations (much like this transfer of assets) involve viable
20 and usually well-funded water or wastewater utilities. Staff of the Commission have
21 encouraged consolidation of small, distressed water and wastewater utilities. The ones with
22 20, 50, or 100 ratepayers – we have a lot of them in Arizona. Unfortunately, it is very difficult
23 for an operator to acquire and make such small utilities profitable. These are the ones that
24 Staff stands ready to consider premiums and other incentives for, but Staff has not noted a
25 great deal of interest in consolidating healthy utilities with these troubled utilities.

26 **Q. Have you reviewed the rebuttal testimony of EWAZ witness, Shawn Bradford?**

1 A. Yes I have. While Staff appreciates the difficulties that can be encountered in running a
2 utility with vast maintenance needs, Staff believes that ratepayers are none-the-less entitled to
3 receive safe and reliable service. If systems are poorly maintained, problems can pile up, all
4 while the ratepayers are arguably providing funding to support safe and reliable operations.
5 Staff believes that acquisition premiums and acquisition related incentives should be
6 considered in situations where corrective action may require assistance and/or financial
7 support from a healthier or financially stronger acquiring utility. However, Staff believes it is
8 not in the public interest to provide acquisition related incentives to new utility operators who
9 are really committing to bringing the utility services up to standards that should have been
10 maintained all along.

11
12 **Q. Have you reviewed the rebuttal testimony of EWAZ witness, Sarah Mahler?**

13 A. Yes I have. Staff notes that Ms. Mahler seeks approval of incentives for investing capital in
14 Willow Valley. Staff does not agree that incentives are necessary for a viable utility purchase.
15 Willow Valley is viable. Staff does not agree with labeling Willow Valley a "troubled" utility.
16 Staff has already explained above what it believes qualifies for incentives and Staff does not
17 believe that Willow Valley falls within that description.
18 Staff finds that Global did need outside funding to invest \$3.3 million into the Willow Valley
19 system, as this outstrips the depreciation expense provided by ratepayers for the periods 2006
20 to 2015. However, Staff notes that EWAZ promises expenditures of \$1 million over 5 years
21 after acquisition, but the current rates include \$285,500 annually in depreciation expense from
22 ratepayers. So ratepayers will provide \$1.4 million in funding from depreciation expense in
23 those 5 years. Staff notes that EWAZ will control how that non-cash expense is expended.
24 Further, Staff notes that the tax savings provided by the use of accelerated depreciation is
25 another avenue for funding plant replacements and EWAZ will be beginning new
26 depreciation on all of the Willow Valley plant assets it acquires. So, there are already

1 incentives in place that make this purchase attractive to EWAZ without making ratepayers
2 pay more for equivalent services. The return of EWAZ's investment is sought as a premium
3 for its investment. However, Staff notes that EWAZ receives its return on investment via
4 depreciation expense and a return on its investment via a rate of return on rate base.
5

6 **RECOMMENDATIONS**

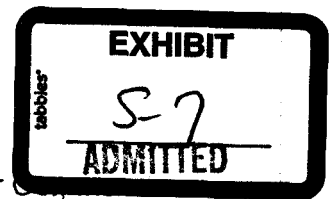
7 **Q. Based on the above, what is Staff recommending?**

8 **A.** Staff recommends approval of the transaction subject to the following conditions:

- 9 1. That the Commission deny recognition of any acquisition premium that EWAZ pays
10 for Willow Valley,
- 11 2. That the Commission deny recognition of any acquisition adjustment or other
12 premium to be applied to expenditures required in the ordinary course of business,
- 13 3. That EWAZ be put on notice that Willow Valley should work towards a balanced
14 capital structure and that a hypothetical capital structure may be deemed appropriate
15 in a future rate proceeding if EWAZ fails to do so,
- 16 4. That EWAZ shall continue to comply with all decisions, and more specifically the
17 requirements of Decision No. 74364 which requires annual reporting of the Willow
18 Valley water losses until such time as annual water losses are less than 10 percent.
19

20 **Q. Does this conclude your surrebuttal testimony?**

21 **A.** Yes, it does.



COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Company
DOCKET NO: W-01732A-15-0131

Response provided by: Joanne Ellsworth
Title: Director Corporate and Regulatory Affairs, Global Water Resources, Inc.

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: STF GWB 2.1

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Please provide a written legal description of the entire service area, as a separate entity, that is being transferred EWAZ.

A: Please see attached Exhibit labeled "STF GWB 2.1 Legal Description – Willow Valley.docx".

Willow Valley Water Co., Inc.

Legal Description of Certificate of Convenience and Necessity Area

to be transferred to

EPCOR Water Arizona, Inc.

ACC Docket Nos.
W-01732A-15-0131
W-01303A-15-0131

Township 18 North, Range 21 West

Section 19

The East Half of the Northwest Quarter (E ½ NW ¼), and the Southeast Quarter of the Southwest Quarter (SE ¼ SW ¼), and the West Half of the Southeast Quarter (W ½ SE ¼) of Section 19, Township 18 North, Range 21 West, of the Gila & Salt River Base and Meridian, Mohave County, Arizona.

Lots 1, 2, 3 and 4 (being the West Half of the West Half [W ½ W ½]), and the Northwest Quarter of the Southwest Quarter (NE ¼ SW ¼) of Section 19, Township 18 North, Range 21 West, of the Gila & Salt River Base and Meridian, Mohave County, Arizona

Township 18 North, Range 22 West

Section 21

Parcel A

All that portion of the abandoned channel of the Colorado River, as it existed immediately prior to re-channelization, that lies South of the North line of fractional Section 21, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian, Mohave County, Arizona, and that lies East of the Easterly dredging right of way line of the present channel of the Colorado River, approximately described as follows:

COMMENCING at the Northeast Corner of said fractional Section 21;
thence S 76° 17' 28" W, along the North line of said fractional Section 21, 2796 feet more or less to the point of beginning, said point being a point on a meander line of the left descending bank of said abandoned channel;
thence S 42° 51' W 250 feet to a point;
thence S 57° 39' W 390 feet to a point;
thence S 78° 45' W 260 feet to a point;
thence S 60° 44' W 200 feet to a point;
thence S 65° 57' W 477 feet to a point;
thence S 39° 51' W 260 feet to a point;
thence S 45° 43' W 390 feet to a point on the Easterly dredging right of way line of said present channel;

thence Northerly along said right of way line, which is a curve to the right, having a tangent that bears N 02° 52' 39" E from the last described point, a radius of 7190.90 feet and a central angle of 6° 17' 40", 790 feet to a point on the North line of said fractional Section 21;
thence N 76° 17' 28" E along the North line of said fractional Section 21, 1778 feet to the true point of beginning. Containing 13.60 Acres more or less.

Parcel B

All that portion of the abandoned channel of the Colorado River, as it existed immediately prior to re-channelization, that lies South of the North line and a Westerly prolongation thereof, of fractional Section 21, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian, Mohave County, Arizona, and that is bounded on the East by the Easterly dredging right of way line of the present channel of the Colorado River and is bounded on the South and East by the left descending bank of the abandoned channel of the Colorado River as it existed immediately prior to dredging, and is bounded on the West by the left descending bank of the present normal-flow channel of the Colorado River, approximately described as follows:

COMMENCING at the Northeast Corner of said fractional Section 21;
thence S 76° 17' 28" W, along the North line of said fractional Section 21, 4574.36 feet to a point, said point being the intersection of the North line of said fractional Section 21 and said Easterly dredging right of way line of the present channel of the Colorado River and the Point of Beginning;
thence Southerly along said right of way line, which is a curve to the left having a tangent that bears S 09° 10' 19" W from the last described point, a radius of 7190.90 feet and a central angle of 6° 17' 40", 790 feet to a point, said point being a point on a meander line of the left descending bank of said abandoned channel;
thence along a meander line of said abandoned channel S 44° 59' W 579 feet to a point;
thence along a meander line of said abandoned channel S 16° 00' W 418 feet to a point, said point being on a Westerly prolongation of the South riparian Section line of fractional Section 21 as established by the United States Bureau of Land Management and also being a point on a meander line of the left descending bank of the present normal-flow channel of the Colorado River;
thence along said left bank of the present normal-flow channel N 01° 30' E 680 feet to a point;
thence N 10° 02' E 200 feet to a point;
thence N 01° 26' E 220 feet to a point;
thence N 13° 29' E 410 feet to a point, said point being on a Westerly prolongation of the North line of said fractional Section 21;
thence along the North line of said fractional Section 21 and a Westerly prolongation thereof N 76° 17' 28" E 480 feet to the true point of beginning. Containing 11.43 Acres more or less.

Parcel C

All of that portion of the alluvium lands of the Colorado River lying West of and adjoining fractional Section 21, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian, Mohave County, Arizona, bounded on the Northwest by the meander lines of the left descending bank of said River immediately prior to the re-channelization, bounded on the Northeast by the 1905 GLO Meander line, and bounded on the South by a line that is the South riparian section line and follows an existing line of occupation. Said boundaries being approximately described as follows:

COMMENCING at the South quarter corner of said Section 21;
thence South 89° 50' 52" West, a distance of 540.84 feet more or less to the point of beginning, said point being the BLM Brass Cap Monument marking the Meander

Come on the South line of said Section 21;
thence S 82° 18' 43" W 1512.93 feet to a 1 inch iron pipe tagged RLS 5576, said 1
inch iron pipe being on the Easterly prolongation of an existing fence;
thence along said fence S 80° 24' 40" W 421.67 feet to a 1 inch iron pipe tagged RLS
5576, and the Westerly termination of said fence;
thence continuing S 80° 24' 40" W 16 feet more or less to a point on the meander line
of the left descending bank of the Colorado River immediately prior to the re-channelization, said
point also being the most Southerly Corner of Parcel 2 of that
certain Judgment filed January 30, 1976, at Pages 47-49 of Book 391 of Official
Records of said Mohave County, Arizona;
thence along said meander line N 16° 00' E 418 feet;
thence N 44° 59' E 579 feet to a point on the Easterly dredging right of way line of
the present channel, said point also being the most Southerly Corner of Parcel 1 of
the before mentioned Judgment;
thence N 45° 43' E 390 feet to a point on the 1905 GLO Meander line shown on the
Plat as N 53° 00' W 21.40 chains;
thence along said GLO Meander line S 53° 00' E 1387 feet, more or less, to the point
of Beginning. Containing 23.5 acres more or less.

Parcel D

Lots One (1), Two (2), Three (3) and Four (4) and the South Half of the Southeast Quarter (S ½ SE ¼) of
Section 21, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian, Mohave County,
Arizona.

Section 23

The South Half (S ½), and the South Half of the Northeast Quarter (S ½ NE ¼), and the South Half of the
Northwest Quarter (S ½ NW ¼), and the West Half of the Northwest Quarter of the Northwest Quarter (W ½
NW ¼ NW ¼), and the Southeast Quarter of the Northwest Quarter of the Northwest Quarter (SE ¼ NW
¼ NW ¼) and the West Half of the Northeast Quarter of the Northwest Quarter of the Northwest Quarter of
the Northwest Quarter (W ½ NE ¼ NW ¼ NW ¼) of Section 23, Township 18 North, Range 22 West of the
Gila & Salt River Base and Meridian, Mohave County, Arizona.

and

The South ½ of the North ½ and the Northwest ¼ of the Northwest ¼ of Section 23, **except** the East ½ of
the Northeast ¼ of the Northwest ¼ of the Northwest ¼ of Section 23, Township 18 North, Range 22 West
of the Gila & Salt River Base and Meridian, Mohave County, Arizona

Section 25

All of Section 25, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian, Mohave
County, Arizona.

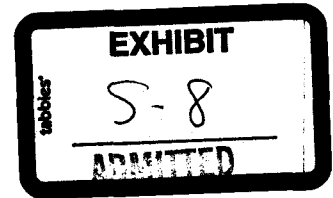
Section 27

All of Section 27, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian

Section 35

North Half (N½) of Section 35, Township 18 North, Range 22 West, Gila & Salt River Base and Meridian,
Mohave County, Arizona.

F:\Rates\BD\2015 Willow Valley\Data Requests\Staff\Staff DR 2\Attachments\STF GWB 2.1 Legal Description – Willow
Valley.docx



BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH

Chairman

BOB STUMP

Commissioner

BOB BURNS

Commissioner

DOUG LITTLE

Commissioner

TOM FORESE

Commissioner

IN THE MATTER OF THE JOINT)
APPLICATION OF WILLOW VALLEY)
WATER CO., INC. AND EPCOR WATER)
ARIZONA INC. FOR APPROVAL OF THE)
SALE OF ASSETS AND TRANSFER OF)
CERTIFICATE OF CONVENIENCE AND)
NECESSITY)
_____)

DOCKET NOS. W-01732A-15-0131
& W-01303A-15-0131

DIRECT

TESTIMONY

OF

JIAN W. LIU

UTILITIES ENGINEER

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

OCTOBER 9, 2015

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1 **INTRODUCTION**

2 **Q. Please state your name, place of employment and job title.**

3 A. My name is Jian W. Liu. My place of employment is the Arizona Corporation Commission
4 ("ACC" or "Commission"), 1200 West Washington Street, Phoenix, Arizona 85007. My job
5 title is Water/Wastewater Engineer with the Commission's Utilities Division Staff ("Staff").
6

7 **Q. How long have you been employed by the Commission?**

8 A. I have been employed by the Commission since October 2005.
9

10 **Q. Please list your duties and responsibilities.**

11 A. My main responsibilities are to inspect, investigate and evaluate water and wastewater
12 systems. This includes obtaining data, preparing reconstruction cost new and/or original cost
13 studies, investigative reports, interpreting rules and regulations, and suggesting corrective
14 action and providing technical recommendations on water and wastewater system
15 deficiencies. I also provide written and oral testimony in rate cases and other cases before the
16 Commission.
17

18 **Q. How many companies have you analyzed for the Utilities Division?**

19 A. I have analyzed approximately 50 companies fulfilling these various responsibilities for the
20 Commission's Utilities Division.
21

22 **Q. Have you previously testified before this Commission?**

23 A. Yes, I have testified before the Commission.
24

1 **Q. What is your educational background?**

2 A. I am a Ph.D. Candidate in Geotechnical Engineering from Arizona State University ("ASU").
3 I have a Master of Science Degree in Natural Science from ASU and a Master of Science
4 Degree in Civil Engineering from Institute of Rock & Soil Mechanics ("IRSM"), Academy of
5 Sciences, China.

6
7 **Q. Briefly describe your pertinent work experience.**

8 A. From 1982 to 2000, I was employed by IRSM, SCS Engineers, and URS Corporation as a
9 Civil and Environmental Engineer. In 2000, I joined the Arizona Department of
10 Environmental Quality ("ADEQ"). My responsibilities with ADEQ included review and
11 approval of water distribution systems, sewer distribution systems, and on-site wastewater
12 treatment facilities. I remained with ADEQ until transferring to the Commission in October
13 2005.

14
15 **Q. Please state your professional membership, registrations, and licenses.**

16 A. I am a licensed professional civil engineer in the State of Arizona.
17

18 **PURPOSE OF TESTIMONY**

19 **Q. What was your assignment in this proceeding?**

20 A. My assignment was to provide Staff's engineering evaluation of the application. I reviewed
21 the Company's application and responses to data requests. This testimony and its attachment
22 present Staff's engineering evaluation. The findings of my engineering evaluation are
23 contained in the Engineering Report that I have prepared for this proceeding. The report is
24 included as Exhibit JWL in this pre-filed testimony.
25

1 **RECOMMENDATIONS AND CONCLUSIONS**

2 **Q. What are Staff's conclusions and recommendations regarding the Company's**
3 **operations?**

4 **A. Staff's conclusions and recommendations regarding the Company's operations are contained**
5 **in the attached Engineering Report.**

6
7 **Q. Does this conclude your Direct Testimony?**

8 **A. Yes, it does.**

EXHIBIT JW

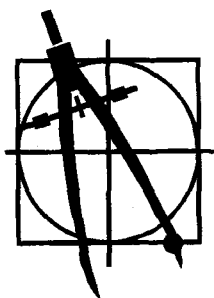
ENGINEERING REPORT FOR

WILLOW VALLEY WATER CO., INC.

DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131

JIAN W LIU

OCTOBER 7, 2015



**ENGINEERING REPORT for:
Joint Application of Willow Valley Water
Co., Inc. and EPCOR Water Arizona Inc.
for Approval to Sale the Assets and
Transfer of the Certificate of Convenience
and Necessity
Docket Nos. W-01732A-15-0131 and W-
01303A-15-0131**

By: Jian W Liu, Utilities Engineer

OCTOBER 7, 2015

EXECUTIVE SUMMARY

CONCLUSIONS:

1. The Arizona Department of Environmental Quality ("ADEQ") reported that the Willow Valley water systems are currently delivering water that meets water quality standards required by 40 C.F.R. 141 (National Primary Drinking Water Regulations) and Arizona Administrative Code, Title 18, Chapter 4.
2. Willow Valley Water Co., Inc. ("Willow Valley") is not located within an Arizona Department of Water Resources ("ADWR") Active Management Area ("AMA") and is not subject to any ADWR AMA reporting and conservation requirements. ADWR has determined that Willow Valley is currently in compliance with departmental requirements governing water providers and/or community water systems.
3. A check with the Arizona Corporation Commission ("ACC" or "Commission") Utilities Division Compliance Section showed no delinquent compliance items for the Willow Valley.
4. Staff concludes that Willow Valley water systems have adequate production capacity and storage capacity to serve the existing customer base and reasonable growth.

RECOMMENDATION

1. Staff recommends that EPCOR Water Arizona Inc. ("EWAZ") prepare a report containing a detailed analysis and plan to reduce water loss to 10 percent or less for Willow Valley water systems. If the EWAZ believes it is not cost effective to reduce the water loss to less than 10 percent, it should submit a detailed cost benefit analysis to support its opinion. In no case shall the EWAZ allow water loss to be greater than 15 percent. The water loss reduction report or the cost benefit analysis shall be docketed as a compliance item within 90 days of the effective date of the order issued in this proceeding if this application is approved.

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A. INTRODUCTION

On April 22, 2015, Willow Valley Water Co., Inc. ("Willow Valley") and EPCOR Water Arizona Inc. ("EWAZ") filed an application requesting that the Arizona Corporation Commission ("ACC" or "Commission") approve the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ.

Willow Valley's ultimate parent company, Global Water Resources, Inc. ("Global"), now seeks to focus on its core service areas in Maricopa and Pinal Counties and on its core business strategy of providing regionally integrated water and wastewater service. As a result, Global has decided to divest Willow Valley's two potable water systems located in Mohave County, well outside its core service area.

EWAZ is an Arizona public service corporation, authorized to provide water service in nine districts in Arizona. Among the water districts operated by EWAZ are the Mohave and North Mohave Water Districts, located approximately ten miles north of Willow Valley's certificated service area. EWAZ currently serves approximately 128,000 water customers throughout Arizona, including approximately 16,000 in its Mohave Water District and 2,000 in its North Mohave Water District. EWAZ has a significant presence in the Mohave County area which should result in economies of scale savings for Willow Valley in the future.

On June 1, 2015, EWAZ filed a supplemental application to seek recovery of approximately \$226,000 through a surcharge mechanism to be approved as part of the sale of Willow Valley's utility system and transfer of its CC&N to EWAZ.

B. WATER SYSTEM

Willow Valley

Willow Valley is an Arizona public service corporation, authorized to provide water utility service in a portion of Mohave County, Arizona under a CC&N granted in Commission Decisions Nos. 32436, 34869, 55434 and 68610. Willow Valley currently serves approximately 1,620 connections in its existing service area of approximately 4.29 square miles. Willow Valley's current water systems consist of 10 wells, with a total capacity of 1,765 gallons per minute ("GPM"); 4 storage tanks, with a combined capacity of 502,000 gallons; 12 booster pump stations; and associated distribution systems. Staff concludes that the system has adequate production and storage capacity to serve existing customers and reasonable growth.

Non-Account Water

Non-account water should be 10 percent or less. It is important to be able to reconcile the difference between water sold and the water produced by the source. A water balance will allow a company to identify water and revenue losses due to leakage, theft and flushing.

Willow Valley reported the following gallons pumped and gallons sold in 2014, which Staff used to determine the water loss per system:

Water Loss

Water System	Gallons Pumped	Gallons Sold	Water loss (%)
King Street, PWS 08-040	76,402,000	53,335,000	30.19
Lake Cimarron, PWS 08-129	8,281,000	7,841,000	5.31*

*Based on the updated 2014 Water Use Data Sheet for the Willow Valley – Lake Cimarron system, provided to Staff on September 18, 2015.

Decision No. 74364 (February 26, 2014) requires that Valencia Water Company – Town Division (“Valencia-Town”), Water Utility of Northern Scottsdale (“WUNS”), Water Utility of Greater Tonopah (“WUGT”), Valencia Water Company - Greater Buckeye Division (“Valencia - Greater Buckeye”), Global Water - Santa Cruz Water Company (“Santa Cruz”) and Willow Valley Water Company (“Willow Valley”) file their water loss report consistent with the Settlement Agreement and the Decision. Accordingly, Global filed its water loss report on May 30, 2014, and May 29, 2015.

Staff recommends that EWAZ prepare a report containing a detailed analysis and plan to reduce water loss to 10 percent or less for Willow Valley water systems. If the EWAZ believes it is not cost effective to reduce the water loss to less than 10 percent, it should submit a detailed cost benefit analysis to support its opinion. In no case shall the EWAZ allow water loss to be greater than 15 percent. The water loss reduction report or the cost benefit analysis shall be docketed as a compliance item within 90 days of the effective date of the order issued in this proceeding if this application is approved.

C. ARIZONA DEPARTMENT OF ENVIRONMENTAL QUALITY (“ADEQ”) COMPLIANCE

ADEQ reported that Willow Valley water systems have no major deficiencies and are delivering water that meets water quality standards required by 40 CFR 141 (Title 40 Code of Federal Regulations Part 141 National Primary Drinking Water Regulations) and Arizona Administrative Code, Title 18, Chapter 4.¹

E. ARIZONA DEPARTMENT OF WATER RESOURCES (“ADWR”) COMPLIANCE

Willow Valley is not located within an ADWR Active Management Area (“AMA”) and is not subject to any ADWR AMA reporting and conservation requirements. ADWR has determined that Willow

¹ Staff received ADEQ Water Quality Compliance Status Reports dated June 3, 2015.

Valley is currently in compliance with departmental requirements governing water providers and/or community water systems.²

F. ACC COMPLIANCE

A check of the Utilities Division compliance database indicates that there are currently no delinquent compliance items for Willow Valley.³

G. TARIFF

1. Curtailment Tariff

Willow Valley has an approved Curtailment tariff on file with the ACC.

2. Cross Connection & Backflow Tariff

Willow Valley has an approved Backflow Prevention tariff on file with the ACC.

3. Best Management Practice ("BMP") Tariff

Willow Valley also has approved BMP tariffs on file with the Commission.

² Per ADWR Water Provider Compliance Status Reports dated May 7, 2015.

³ Per Compliance Section email dated April 29, 2015.

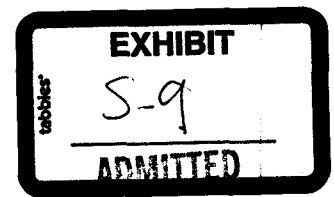


EXHIBIT JWL-6

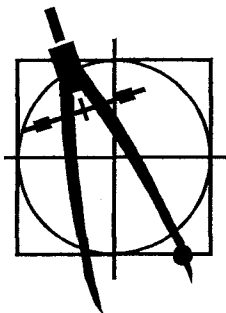
ENGINEERING REPORT FOR

WILLOW VALLEY WATER CO., INC.

DOCKET NO. W-01732A-12-0315 (RATES)

JIAN W LIU

June 3, 2013



Engineering Report for WILLOW VALLEY WATER CO., INC.

Docket No. W-01732A-12-0315 (Rates)

By: **Jian Liu**
Utilities Engineer

June 3, 2013

CONCLUSIONS

1. Arizona Department of Environmental Quality ("ADEQ") reported that the Willow Valley Water Co., Inc. ("Willow Valley" or the "Company") drinking water systems are currently delivering water that meets water quality standards required by 40 C.F.R. 141 (Title 40 Code of Federal Regulations Part 141 National Primary Drinking Water Regulations) and Arizona Administrative Code, Title 18, Chapter 4. (ADEQ report dated April 8, 2013).
2. The Company is not located in any Active Management Area ("AMA") and is not subject to any AMA reporting and conservation requirements. ADWR reported that Willow Valley is currently in compliance with departmental requirements governing water providers and/or community water systems. (ADWR compliance status report dated March 13, 2013).
3. A check with the Utilities Division Compliance Section showed no delinquent compliance items for Willow Valley. (ACC Compliance Section Email dated May 17, 2013).
4. Willow Valley has approved Curtailment Plan and Backflow Prevention Tariffs on file with the Commission.
5. The Company also has three approved Best Management Practice ("BMP") tariffs on file with the Commission.
6. Staff concludes that Willow Valley has adequate production capacity and storage capacity to serve the existing customer base and reasonable growth.
7. Staff inspected the plant facilities on April 16, 2013. The post-test year plant addition was not in-service during Staff's inspection. According to the Company project has been delayed and will not be completed until late 2013. (see Section I for details).

RECOMMENDATIONS

1. In the prior rate case, the Company adopted Staff's typical and customary water depreciation rates. These rates are presented in Table B and it is recommended that the Company continue to use these depreciation rates by individual National Association of Regulatory Utility Commissioners category.
2. Staff recommends the annual water testing expense of \$15,708 (rounded) be used for purposes of this application.
3. Staff recommends that the Company file each May a report covering the previous calendar year (with the first report due in May 2014 to cover the year of 2013) that contains all work activities undertaken in accordance with Decision No. 71878 regarding the Company's plan for reducing water loss below 10 percent. Staff further recommends that the written report continue until the water loss for all Willow Valley water systems is 10 percent or less for one full calendar year.
4. The Company has not requested any changes in its service line and meter installation charges that were approved in its last rate application. Therefore, Staff recommends continued use of the Company's current meter and service line installation charges.

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A. LOCATION OF COMPANY

Willow Valley Water Co., Inc. ("Willow Valley" or the "Company") is an Arizona public service corporation authorized to provide water service within portions of Mohave County, Arizona. Willow Valley provides service to approximately 1,500 active connections. Figure 1 shows the location of Willow Valley within Mohave County and Figure 2 shows the certificated area.

B. DESCRIPTION OF THE WATER SYSTEMS

The plant facilities were visited on April 16, 2013, by Jian Liu, Staff Utilities Engineer, in the accompaniment of Joel Wade, and Justin Waters of the Company. The Company operates two independent water systems. Brief descriptions of the two systems are as follows:

1. King Street, Public Water System ("PWS") 08-040: This system consists of two wells producing a total of 800 gallons per minute ("gpm"), three storage tanks, eight booster pumps, three pressure tanks, Iron and Manganese removal systems and a distribution system. This system served 1,374 active connections at the end of 2011.
2. Lake Cimarron, PWS 08-129: This system consists of two wells, producing a total of 415 gpm, a storage tank, four booster pumps, a pressure tank and a distribution system. There is an Iron and Manganese removal system. This system served 128 active connections at the end of 2011.

Detailed plant facility listings are as follows:

King Street, PWS 08-040

Well Data (active wells only)

Location/No.	ADWR ID	Pump Hp	Pump GPM	Casing Size	Casing Depth (Feet)	Meter Size
Unit 17 - Secondary	55-603949	15	300	8"	100	4"
Unit 17 - Primary	55-208170	30	500	9"	120	6"
Total Production	-	-	800	-	-	-

Storage Tanks		Pressure Tanks		Booster Pumps	
Capacity (gallons)	Quantity	Capacity (gallons)	Quantity	Capacity (HP)	Quantity
163,000	1	14,000	1	15	6
47,000	1	5,200	1	30	1
96,000	1	2,200	1	40	1
Total 306,000					

Mains		Customer Meters		Fire Hydrants
Size (inches)	Length (feet)	Size (inches)	Quantity	Quantity
2	904	5/8x3/4	1,450	46
3	1,587	3/4	9	
4	68,093	1	15	
6	28,368	1.5	2	
8	4,220	2	2	
Unknown	122	4	2	
		6	2	
		Total Metered Connections	1,482	

Lake Cimarron, PWS 08-129

Well Data (active wells only)

Location/No.	ADWR ID #	Pump Hp	Pump GPM	Casing Size	Casing Depth (Feet)	Meter Size
Lake Cimarron Small	55-604161	10	225	6"	100	4"
Lake Cimarron Large	55-604160	7.5	190	12"	60	4"
Total Production	-	-	415	-	-	-

Storage Tanks		Pressure Tanks		Booster Pumps	
Capacity (gallons)	Quantity	Capacity (gallons)	Quantity	Capacity (HP)	Quantity
196,000	1	5,800	1	20	2
				25	2
Total 196,000					

Mains		Customer Meters		Fire Hydrants
Size (inches)	Length (feet)	Size (inches)	Quantity	Quantity
4	297	5/8x3/4	130	19
6	880	3/4	1	
8	11,866	2	1	
10	6,161	Total Metered Connections	132	

C. WATER USE

Water Sold

Based on the information provided by the Company in its Water Use Data Sheets, water use for the year 2011 is presented below for each system.

Water Use, gallons per day ("GPD") per connection

Water System Name	High	Low	Average
King Street, PWS 08-040	189 in Sept.	111 in Feb&Mar	136
Lake Cimarron, PWS 08-129	246 in Sept.	152 in Nov.	177

Non-Account Water

For each water system, the Company reported the following gallons pumped and gallons sold in 2011, which Staff used to determine the water loss per system:

Water Loss

Water System	Gallons Pumped	Gallons Sold	Water loss (%)
King Street, PWS 08-040	89,824,000	68,713,000	23.5
Lake Cimarron, PWS 08-129	10,806,000	8,300,000	23.19

Non-account water should be 10 percent or less and never more than 15 percent. It is important to be able to reconcile the difference between water sold and the water produced by the source. A water balance will allow a water company to identify water and revenue losses due to leakage, theft, and flushing.

Decision No. 71878 (September 15, 2010) requires the 10 Global water systems, to file a detailed plan demonstrating how the various systems will reduce their water loss to less than 10 percent. On December 14, 2010, Global Water filed a plan for reducing water loss to below 10 percent in the 10 Global Utilities' water systems, including the two Willow Valley water systems:

- King Street, PWS 08-040
- Lake Cimarron, PWS 08-129

Water loss for the above two water systems continued to exceed the Staff's recommended threshold of 10 percent in 2011. Staff recommends that the Company file each May a report covering the previous calendar year (with the first report due in May 2014 to cover the year of 2013) that contains all work activities undertaken in accordance with Decision No. 71878 regarding the Company's plan for reducing water loss below 10 percent. Staff further recommends that the written report continue until the water loss for all Willow Valley water systems is 10 percent or less for one full calendar year.

D. GROWTH

In July 2009, the Company had 1,528 customers, and in December 2011, the Company had 1,502 customers. Willow Valley lost 26 customers from July 2009 to December 2011. The Company estimates that the customer base will remain the same (with little or no growth) for the next 5 years.

Staff concludes that the Willow Valley has adequate production capacity and storage capacity to serve the existing customer base and reasonable growth.

E. ARIZONA DEPARTMENT OF ENVIRONMENTAL QUALITY COMPLIANCE ("ADEQ")

Compliance

ADEQ reported that the Willow Valley drinking water systems are currently delivering water that meets water quality standards required by 40 C.F.R. 141 (Title 40 Code of Federal Regulations Part 141 National Primary Drinking Water Regulations) and Arizona Administrative Code, Title 18, Chapter 4. (ADEQ report dated April 8, 2013).

Water Testing Expense

Willow Valley reported a total testing expense of \$20,992.93 during the test year, the Company provided invoices and other documents to support this amount.

Willow Valley reported the following annual water testing expense for last 4 years (rounded):

Year 2009 - \$16,874
Year 2010 - \$11,252
Year 2011 - \$20,993
Year 2012 - \$13,712

Therefore, average annual water testing expense from 2009 to 2012 is \$15,707.75. Staff reviewed these expenses and supporting documentation provided by the Company. Staff recommends the annual water testing expense of \$15,708 (rounded) be used for purposes of this application.

F. ARIZONA DEPARTMENT OF WATER RESOURCES ("ADWR") COMPLIANCE

The Company is not located in any Active Management Area ("AMA") and is not subject to any ADWR AMA reporting and conservation requirements. ADWR reported that Willow Valley is currently in compliance with departmental requirements governing water providers and/or community water systems. (ADWR compliance status report dated March 13, 2013).

G. ARIZONA CORPORATION COMMISSION ("ACC") COMPLIANCE

A check with the ACC Utilities Division Compliance Section showed no delinquent compliance items for the Company. (ACC Compliance Section Email dated May 17, 2013).

H. DEPRECIATION RATES

In the prior rate case, the Company adopted Staff's typical and customary water depreciation rates. These rates are presented in Table B and it is recommended that the Company continue to use these depreciation rates by individual National Association of Regulatory Utility Commissioners category.

Table B. Depreciation Rates

NARUC Acct. No.	Depreciable Plant	Average Service Life (Years)	Annual Accrual Rate (%)
304	Structures & Improvements	30	3.33
305	Collecting & Impounding Reservoirs	40	2.50
306	Lake, River, Canal Intakes	40	2.50
307	Wells & Springs	30	3.33
308	Infiltration Galleries	15	6.67
309	Raw Water Supply Mains	50	2.00
310	Power Generation Equipment	20	5.00
311	Pumping Equipment	8	12.5
320	Water Treatment Equipment		
320.1	Water Treatment Plants	30	3.33
320.2	Solution Chemical Feeders	5	20.0
330	Distribution Reservoirs & Standpipes		
330.1	Storage Tanks	45	2.22
330.2	Pressure Tanks	20	5.00
331	Transmission & Distribution Mains	50	2.00
333	Services	30	3.33
334	Meters	12	8.33
335	Hydrants	50	2.00
336	Backflow Prevention Devices	15	6.67
339	Other Plant & Misc Equipment	15	6.67
340	Office Furniture & Equipment	15	6.67
340.1	Computers & Software	3	33.33
341	Transportation Equipment	5	20.00
342	Stores Equipment	25	4.00
343	Tools, Shop & Garage Equipment	20	5.00
344	Laboratory Equipment	10	10.00
345	Power Operated Equipment	20	5.00
346	Communication Equipment	10	10.00
347	Miscellaneous Equipment	10	10.00
348	Other Tangible Plant	---	---

NOTES:

- These depreciation rates represent average expected rates. Water companies may experience different rates due to variations in construction, environment, or the physical and chemical characteristics of the water.
- Acct. 348, Other Tangible Plant may vary from 5% to 50%. The depreciation rate would be set in accordance with the specific capital items in this account.

I. POST-TEST YEAR PLANT

The Company submitted one post-test year plant addition for inclusion in rate base, the West Valley Region Supervisory Control and Data Acquisition ("SCADA") system for Willow Valley Water Company.

Staff inspected the plant facilities on April 16, 2013. This post-test year plant addition was not in-service during Staff's inspection. According to the Company its SCADA project has been delayed and will not be completed until late 2013.

J. OTHER ISSUES

1. Curtailment, Backflow Prevention and Best Management Practice ("BMP") Tariffs

Willow Valley has approved Curtailment and Backflow Prevention tariffs on file with the ACC.

The Company also has three approved BMP tariffs on file with the Commission.

2. Service Line and Meter Installation Charges

The Company has not requested any changes in its service line and meter installation charges that were approved in its last rate application. Therefore, Staff recommends continued use of the Company's current meter and service line installation charges.

Willow Valley Water Co., Inc.
Docket No. W-01732A-12-0315 (Rates)

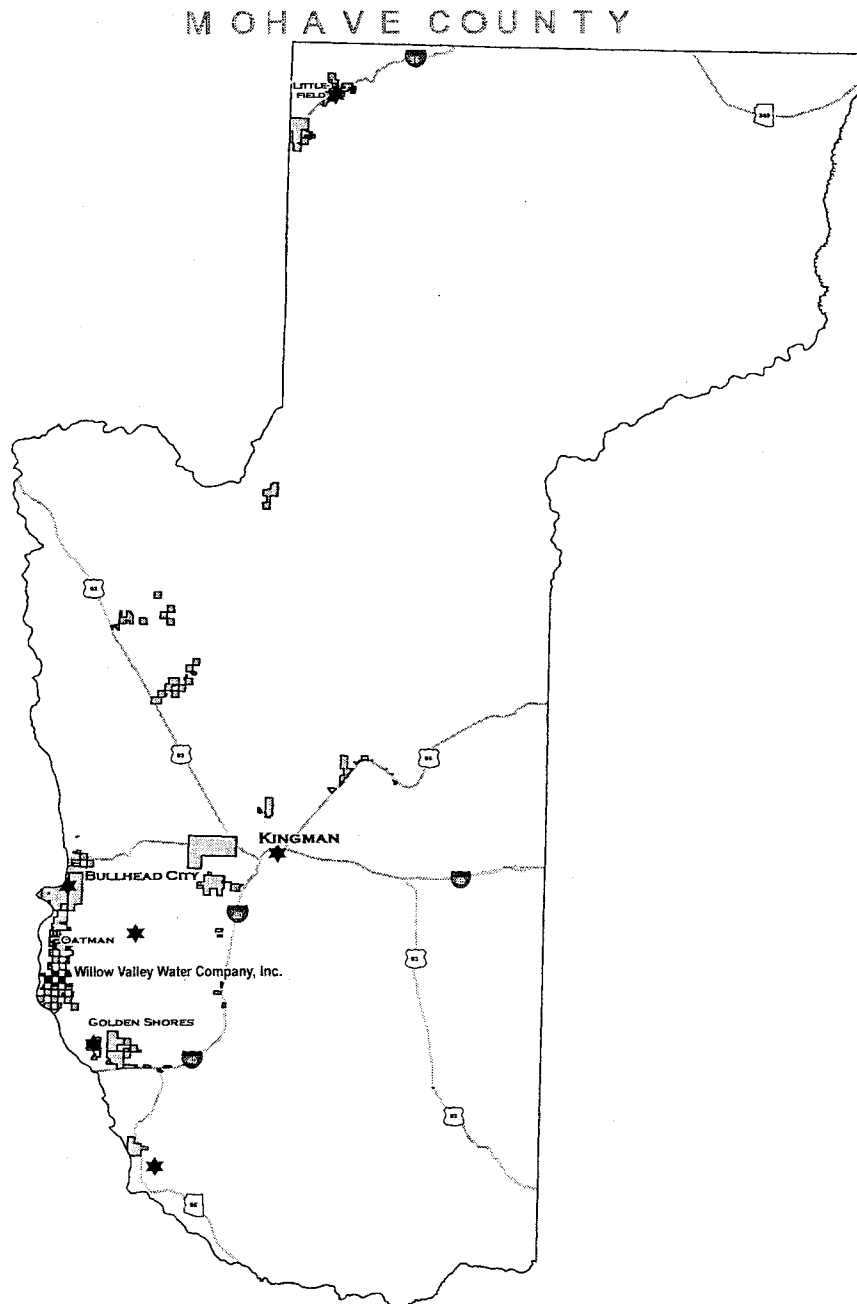


Figure 1. County Map

Willow Valley Water Co., Inc.
Docket No. W-01732A-12-0315 (Rates)

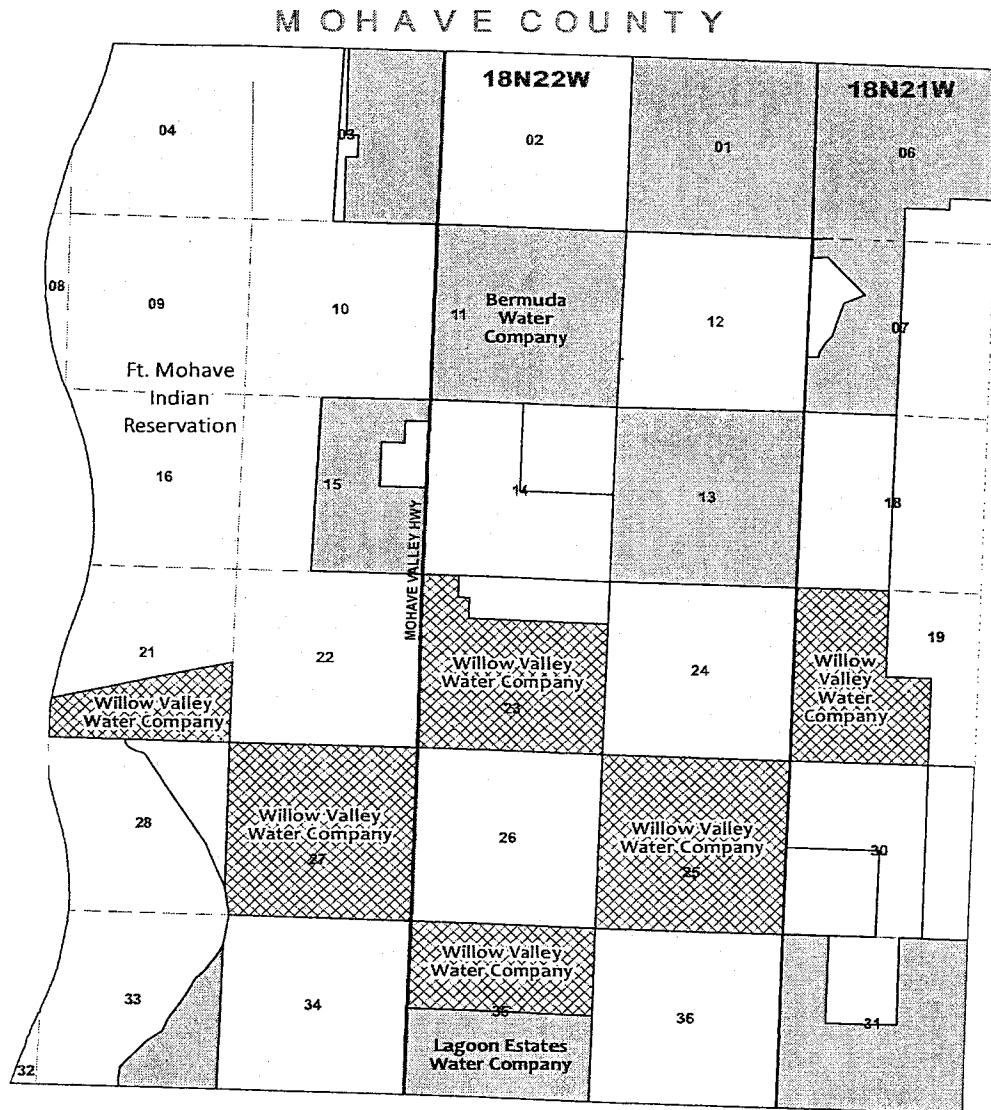


Figure 2. Certificated Areas

BEFORE THE ARIZONA CORPORATION COMMISSION

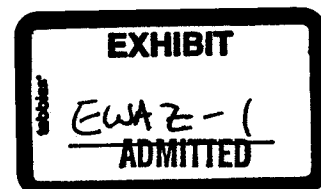
COMMISSIONERS

SUSAN BITTER SMITH, Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION OF
WILLOW VALLEY WATER CO., INC. AND EPCOR
WATER ARIZONA, INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

DOCKET NOS: W-01732A-15-0131
W-01303A-15-0131

**REBUTTAL TESTIMONY
OF
SHAWN BRADFORD
ON BEHALF OF
EPCOR WATER ARIZONA, INC.
OCTOBER 23, 2015**



**REBUTTAL TESTIMONY
OF
SHAWN BRADFORD
ON BEHALF OF
EPCOR WATER ARIZONA, INC.
OCTOBER 23, 2015**

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1 **EXECUTIVE SUMMARY**

2 Mr. Bradford's Rebuttal Testimony supports the Acquisition Adjustment mechanism proposed
3 by the Company in this proceeding and responds to issues related to acquisition premium that
4 were raised in the Direct Testimony filed on behalf of the Utilities Division Staff and the
5 Residential Utility Consumer Office.

1 **I. INTRODUCTION AND QUALIFICATIONS**

2 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND TELEPHONE**
3 **NUMBER.**

4 A. My name is Shawn Bradford. My business address is 2355 W. Pinnacle Peak Road, Suite
5 300, Phoenix, Arizona 85027, and my business phone is (623) 815-3136.

6 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

7 A. I am employed by EPCOR Water (USA) Inc. ("EWUS"), the owner of EPCOR Water
8 Arizona, Inc. ("EWAZ" or "Company"), as the Vice President of Corporate Services.

9 **Q. PLEASE DESCRIBE YOUR RESPONSIBILITIES WITH EWUS.**

10 A. My primary responsibilities for EWUS include the management of the Customer Care &
11 Billing, Public & Governmental Affairs, Information Technology and the Rates &
12 Regulatory Departments.

13 **Q PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AND**
14 **EDUCATION.**

15 A. I have been employed by EWUS since February 1, 2012. Prior to EWUS's acquisition of
16 the American Water operations in Arizona and New Mexico, I worked for Arizona-
17 American Water beginning in the fall of 2011.

18 I have over 26 years of experience in the water and wastewater industry, with experience
19 at all levels, including management, operations, and maintenance. Prior to my current
20 position with EWUS as the Vice President of Corporate Services, I served as the Director
21 of Operations for the Central Division of EWAZ and was responsible for over 81,000
22 water and 45,000 sewer connections in the Sun City, Sun City West, and Agua Fria
23 Districts.

1 I possess a Master of Business Administration Degree with a focus on Strategic
2 Leadership from Amberton University as well as a Bachelor of Science Degree in
3 Management from Becker College and an Associate's Degree in Environmental
4 Engineering from Northeastern University.

5 **II. PURPOSE OF TESTIMONY**

6 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?**

7 A. The purpose of my testimony is to respond to recommendations of the Arizona
8 Corporation Commission Staff ("Staff") to deny recovery of an acquisition premium.

9 **III. STAFF'S RECOMMENDATION TO DENY RECOVERY OF ACQUISITION**
10 **PREMIUM**

11 **Q. HAVE YOU REVIEWED THE BASIS OF THE STAFF'S AND RUCO'S**
12 **RECOMMENDATIONS TO DENY RECOVERY OF AN ACQUISITION**
13 **PREMIUM IN THIS CASE?**

14 A. Yes.

15 **Q. HOW DOES THE COMPANY RESPOND TO THEIR RECOMMENDATIONS?**

16 A. The Company disagrees with the Staff's recommendation to deny recognition of any
17 acquisition adjustment or other premium to be applied to expenditures required in the
18 ordinary course of business. The Company has identified additional capital investments
19 that will improve and enhance the operation of the Willow Valley system in the near term
20 as well as address water loss concerns. By providing recovery of the purchase price,
21 which includes a premium, the Commission will support the concept of small system
22 consolidation and enable the new owner to effectively manage risk by making these
23 investments to improve the operations of the Willow Valley system.

1 **IV. EWAZ'S ADDITIONAL CAPITAL INVESTMENT PLAN**

2 **Q. PLEASE DESCRIBE THE CAPITAL INVESTMENT PLAN CONTEMPLATED**
3 **BY THE COMPANY TO ADDRESS EXCESSIVE WATER LOSS IN THE**
4 **WILLOW VALLEY SYSTEM.**

5 A. EWAZ has identified system-wide needs during our initial due diligence review of the
6 Willow Valley system. Based on our review to date, we currently estimate a needed
7 investment of approximately \$1.0 million over the first five years to address existing
8 water losses and to improve the overall operability of the system. Projects identified to
9 date include:

- 10 1) Replacement of distribution valves that are currently inoperable,
- 11 2) Maintenance and repairs to the three existing storage tanks,
- 12 3) Redesign of the backwash effluent discharge retention system to prevent leaching
13 into the aquifer,
- 14 4) Replacement of leaking service lines,
- 15 5) Repair or replacement of failed flow, backwash, and customer meters as well as
16 other infrastructure projects that may be identified after the transfer of ownership
17 is completed; and
- 18 6) System interconnect between the King Street and Lake Cimarron areas of the
19 existing Willow Valley system to provide operational flexibility and redundancy.

20 **Q. WHY SHOULD THE COMPANY'S PROPOSED ACQUISITION ADJUSTMENT**
21 **BE ADOPTED?**

22 A. EWAZ will need to make significant capital investments to increase the reliability and
23 quality of the Willow Valley system. The acquisition adjustment described in the

1 testimony of the Company's other witness, Ms. Sarah Mahler, would provide EWAZ the
2 opportunity to recover the purchase price premium but only if the Company makes the
3 necessary investments to improve the Willow Valley system.

4 **Q. WHAT ASSURANCES IS THE COMPANY WILLING TO MAKE IF THE**
5 **COMMISSION SUPPORTS THE ACQUISITION ADJUSTMENT CURRENTLY**
6 **PROPOSED?**

7 A. If the sale is approved with the requested acquisition adjustment, the Company will
8 develop and file a Plan of Administration ("POA") within 90 days of the decision. The
9 POA will include a detailed plan to address non-revenue water, which based on our
10 understanding is currently at 26%, as well as additional capital improvements not
11 identified during the Company's initial due diligence review.

12 EWUS has a demonstrated approach to identify and reduce water loss in its existing
13 systems, and this same approach will be applied in the Willow Valley system. The plan
14 that is developed will be used to reduce non-revenue water by 25% within the first 5
15 years of ownership by EWUS and includes the following areas:

- 16 1) Production Meters – the location of all production meters will be verified and
17 tested to confirm accurate operation.
- 18 2) Customer Meter Replacement Program – a program will be developed to begin
19 the immediate replacement of all customer meters that are more than 12 years old.
- 20 3) Zero and Low Usage Meter Report – reports will be developed to identify meters
21 that are currently in service but are registering low or zero usage.
- 22 4) Large meter testing – all meters larger than 2 inches will be tested annually.

- 1 5) Acoustic Leak Detection – existing acoustic leak detection equipment will be
- 2 used to identify system leaks that are not surfacing. Under this program, detected
- 3 leaks are immediately repaired.
- 4 6) Targeted theft prevention – implement a program that is focused on water theft
- 5 from fire hydrants.
- 6 7) Customer Awareness and Reporting Education – routinely distribute educational
- 7 material that allows customers to report any potential or suspected water leaks
- 8 throughout the distribution system.

9 **Q. WHAT HAPPENS IF THE COMPANY FALLS SHORT OF ITS GOAL TO**
10 **REDUCE WATER LOSS BY 25% IN THE FIRST FIVE YEARS?**

11 A. Under the Company's proposal, during a subsequent rate case a surcharge would be
12 authorized to collect the requested premium. Any surcharge in effect at the end of the
13 five year period would cease if water loss has not been reduced by 25% and would not
14 resume until the Company has demonstrated that the system's water loss is declining.

15 **Q. HOW WOULD THESE IMPROVEMENTS SPECIFICALLY PROVIDE A**
16 **BENEFIT TO THE EXISTING CUSTOMERS IN WILLOW VALLEY?**

17 A. As EWAZ's planned capital improvements are completed, customers in Willow Valley
18 will be provided with much more reliable water service. Examples of the improvements
19 include:
20 1) Replacement of distribution valves will minimize system outages and provide greater
21 flexibility when proactive improvements are needed;
22 2) As leaks in services lines or water mains are repaired or replaced system wide, water
23 loss will be reduced which lowers operating costs;

Page 6 of 6

- 1 3) The storage tanks will be configured to meet peak system demand which will
2 maintain adequate water pressure at all times; and
3 4) The planned interconnect between the King Street and Lake Cimarron areas will
4 provide added operational flexibility and increased reliability of supply that does not
5 exist today.

6 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

7 **A. Yes.**

NEW APPLICATION



RECEIVED

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH
Chairman

BOB STUMP
Commissioner

BOB BURNS
Commissioner

TOM FORESE
Commissioner

DOUG LITTLE
Commissioner

Arizona Corporation Commission

DOCKETED

APR 22 2015

DOCKETED BY

ORIGINAL

EXHIBIT

EWAZ-2
ADMITTED

IN THE MATTER OF THE JOINT
APPLICATION OF WILLOW VALLEY
WATER CO., INC. AND EPCOR WATER
ARIZONA INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

DOCKET NO. W-01732A-15-0131
W-01303A-15-0131

APPLICATION

Willow Valley Water Co., Inc. ("Willow Valley") and EPCOR Water Arizona Inc. ("EWAZ") (collectively, the "Applicants") request that the Arizona Corporation Commission ("Commission") approve, pursuant to A.R.S. §§ 40-281, 40-282, 40-285 and A.A.C. R14-2-402, the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ.

I. Introduction

Approval of this Application is in the public interest – it will benefit Willow Valley's customers in several ways and will have no adverse effects. Willow Valley is a Class C water utility located near EWAZ's Mohave Water District. Willow Valley's ultimate parent company, Global Water Resources, Inc. ("Global"), now seeks to focus on its core service areas in Maricopa and Pinal Counties and on its core business strategy of providing regionally integrated water and wastewater service. As a result, Global has decided to divest Willow Valley's two potable water systems located in Mohave County,

201 E. Washington St., Suite 1200
Phoenix, AZ 85004-2595

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1 well outside its core service area. Approving the transfer to EWAZ will allow Willow
2 Valley's customers to continue being served by a well-managed water utility with good
3 water quality, service reliability, and customer service. Due to its location, existing
4 operations and facilities in the area, EWAZ is in the best position to serve Willow Valley's
5 customers efficiently and reliably. Following the close of the acquisition, Willow Valley's
6 former customers will continue to receive water utility service in accordance with the
7 current phased-in tariffed rates approved by the Commission in Decision No. 74364 dated
8 February 26, 2014. As discussed below, EWAZ is also requesting that the Commission
9 approve a mechanism to allow EWAZ to recover the going concern value paid to Global as
10 part of this transaction. EWAZ will serve the former Willow Valley customers as part of a
11 separate Willow Valley water district similar to EWAZ's other water districts.

12 **II. Background**

13 Willow Valley is an Arizona public service corporation, authorized to provide water
14 utility service in a portion of Mohave County, Arizona under a CC&N granted in
15 Commission Decisions Nos. 32436, 34869, 55434 and 68610. A map of its certificated
16 service area is attached as Exhibit A. Willow Valley currently serves approximately 1,620
17 connections in its existing service area of approximately 3.5 square miles. Willow
18 Valley's current water systems consist of 10 wells, with a total capacity of 1,765 gallons
19 per minute; 4 storage tanks, with a combined capacity of 502,000 gallons; 12 booster pump
20 stations; and associated distribution systems. Willow Valley's contact information is as
21 follows:

22 Address: 21410 North 19th Avenue, Suite 220
23 Phoenix, Arizona 85027

24 Telephone number: 623-344-2806

25 Management Contact: Joanne Ellsworth

26 Willow Valley's Annual Report to the Commission for 2014 is attached as Exhibit B. A
copy of Willow Valley's Certificate of Good Standing is attached as Exhibit C. There are

1 no customer complaints against Willow Valley pending with the Commission and no water
2 quality issues with the Arizona Department of Environmental Quality.

3 EWAZ is an Arizona public service corporation, authorized to provide water service
4 in nine districts in Arizona. Among the water districts operated by EWAZ are the Mohave
5 and North Mohave Water Districts, located approximately ten miles north of Willow
6 Valley's certificated service area. Maps showing EWAZ's Mohave County water districts
7 in relation to Willow Valley's service area are attached as Exhibit D. EWAZ currently
8 serves approximately 128,000 water customers throughout Arizona, including
9 approximately 16,000 in its Mohave Water District and 2,000 in its North Mohave Water
10 District. For this Application, EWAZ's contact information is as follows:

11 Address: 2355 W. Pinnacle Peak Road; Suite 300
12 Phoenix, AZ 85027

12 Telephone number: (623) 445-2427

13 Management Contact: Shawn Bradford

14 Portions of EWAZ's Annual Report to the Commission for 2014, including the Balance
15 Sheet and Comparative Statement of Income and Expense, are attached as Exhibit E. A
16 copy of EWAZ's Certificate of Good Standing is attached as Exhibit F.

17 Willow Valley has agreed to sell, and EWAZ has agreed to buy, all of Willow
18 Valley's assets necessary for the operation of Willow Valley's utility systems (the
19 "Transaction"). Willow Valley's most significant assets are its water systems, associated
20 real property, and the permits, certificates, and other approvals which grant Willow Valley
21 the authority to operate its system, including its CC&N. All customer meter deposits,
22 developer deposits, and prepayments under any line extension agreements held by Willow
23 Valley will be transferred to EWAZ as part of the Transaction. EWAZ will assume the
24 refunding obligations, if any, for these deposits and prepayments. Willow Valley will
25 retain all customer security deposits, apply any deposits to its last bill to customers and
26 refund any difference.

1 The Applicants executed their agreement on March 23, 2015, and plan to close the
2 Transaction within 30 days after the Commission's final, non-appealable approval of this
3 Application. EWAZ will pay the full purchase price in cash. The purchase price includes
4 a component of compensation for the going concern value of the Willow Valley systems.
5 EWAZ requests, as part of this Application, that the Commission authorize a mechanism
6 to allow EWAZ to recover that compensation in a timely manner. EWAZ has not finalized
7 the details of the requested mechanism, but will supplement this Application to provide
8 specifics as details are finalized. EWAZ further requests that the Commission find its
9 request is in the public interest as it supports Arizona water industry consolidation,
10 regional planning and economies of scale, operational efficiencies and needed
11 infrastructure investment by allowing EWAZ to acquire a small system located near
12 EWAZ's existing systems, but far from any other system operated by Willow Valley's
13 current owner.

14 The proposed Transaction is not expected to affect any other utility.

15 **III. Benefits of the Transaction.**

16 Approval of this Application will benefit the customers of Willow Valley. The
17 proximity of EWAZ's other water systems presents the opportunity for present and future
18 customers within that service area to benefit from EWAZ's existing operations in Mohave
19 County. Willow Valley's corporate ownership has decided to refocus on its core service
20 areas and its regionally oriented plan to provide integrated water and wastewater service to
21 that core area. As a result, it has decided to divest itself of its Willow Valley operations,
22 which are located several hundred miles from its remaining service areas. As the largest
23 provider of utility service in the Mohave County area, EWAZ will be able to provide a
24 level of service and support to customers that meets or exceeds the service currently
25 provided by Willow Valley.
26

1 Willow Valley's customers will benefit from the in-house water utility expertise
2 and resources afforded by EWAZ ownership. EWAZ's size naturally affords it access to
3 broad in-house utility expertise and resources. The proximity of EWAZ's other systems
4 will provide additional operational resources and personnel. In addition, EWAZ intends to
5 implement or continue various industry best operating practices in the Willow Valley
6 systems. EWAZ uses various sophisticated maintenance and management systems such as
7 maintenance management, environmental and water quality compliance management,
8 hydraulic modeling, and GIS systems. All these support resources will be deployed in
9 support of the Willow Valley systems to provide reliable and high quality service to
10 customers. Those customers will also be integrated into EWAZ's existing customer
11 service, billing, and other systems.

12 Willow Valley's customers will also benefit from EWAZ's financial strength.
13 EWAZ has the financial resources to finance needed infrastructure improvements and
14 future capital and expense requirements, including those that may be required by
15 governmental entities to comply with environmental laws and regulations. EWAZ's
16 financial strength will help keep its cost of long-term debt relatively low.

17 Under Commission Decision No. 74364, Willow Valley's rates are subject to a
18 phase-in, which will continue following approval of the Transaction. EWAZ is not
19 seeking, as part of this Application, to change any of the rates previously approved by the
20 Commission. EWAZ does, however, request that the Commission approve a mechanism
21 that will allow EWAZ to timely recover the going concern value being paid to Willow
22 Valley's corporate parent. As noted above, EWAZ will supplement this Application to
23 provide the specifics of its proposed mechanism as that mechanism is finalized.

24 **IV. Prayer for Relief**

25 Applicants respectfully request that the Commission approve the sale of Willow
26 Valley's assets to EWAZ and the transfer of Willow Valley's CC&N to EWAZ pursuant to

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Phoenix, AZ 85004-2595


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1 A.R.S. §§ 40-281, 40-282, 40-285 and A.A.C. R14-2-402.


2 EWAZ further respectfully requests that the Commission allow it to recover the
3 going concern value paid for Willow Valley and approve the necessary mechanism to
4 allow timely recovery of those amounts.

5 RESPECTFULLY SUBMITTED this 22nd day of April, 2015.

6 LEWIS ROCA ROTHGERBER, LLP

7
8
9
10 
11 Thomas Campbell
12 Stanley B. Lutz
13 201 E. Washington Street
14 Phoenix, AZ 85004
15 (602) 262-5704
16 Attorneys for EPCOR Water Arizona, Inc.

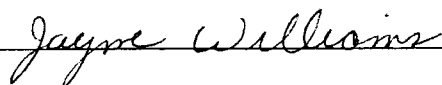
17 SNELL & WILMER L.L.P.

18
19 
20 Timothy Sabo
21 One Arizona Center
22 400 East Van Buren
23 Phoenix, AZ 85004
24 (602) 382-6347
25 Attorneys for Willow Valley Water Co.,
26 Inc.

22 ORIGINAL AND thirteen (13) copies
23 of the foregoing hand-delivered
24 this 22nd day of April, 2015, to:

24 The Arizona Corporation Commission
25 Utilities Division - Docket Control
26 1200 W. Washington Street
Phoenix, Arizona 85007

1 Copy of the foregoing hand-delivered
this 22nd day of April, 2015, to:
2
3 Steve Oleo
Utilities Division
Arizona Corporation Commission
4 1200 W. Washington Street
Phoenix, Arizona 85007
5
6 Lyn Farmer
Chief Administrative Law Judge, Hearing Division
1200 W. Washington Street
7 Phoenix, Arizona 85007
8
9 Janice Alward, Chief Counsel,
Legal Department
Arizona Corporation Commission
10 1200 W. Washington Street
Phoenix, Arizona 85007

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List of Exhibits

Exhibit A – Map of Willow Valley’s CC&N

Exhibit B – Willow Valley’s 2014 Annual Report

Exhibit C – Certificate of Good Standing for Willow Valley

Exhibit D – Maps of EWAZ’s Mohave Valley Districts and Willow Valley CC&N

Exhibit E – Portions of EWAZ’s 2014 Annual Report

Exhibit F – Certificate of Good Standing for EWAZ

EXHIBIT A

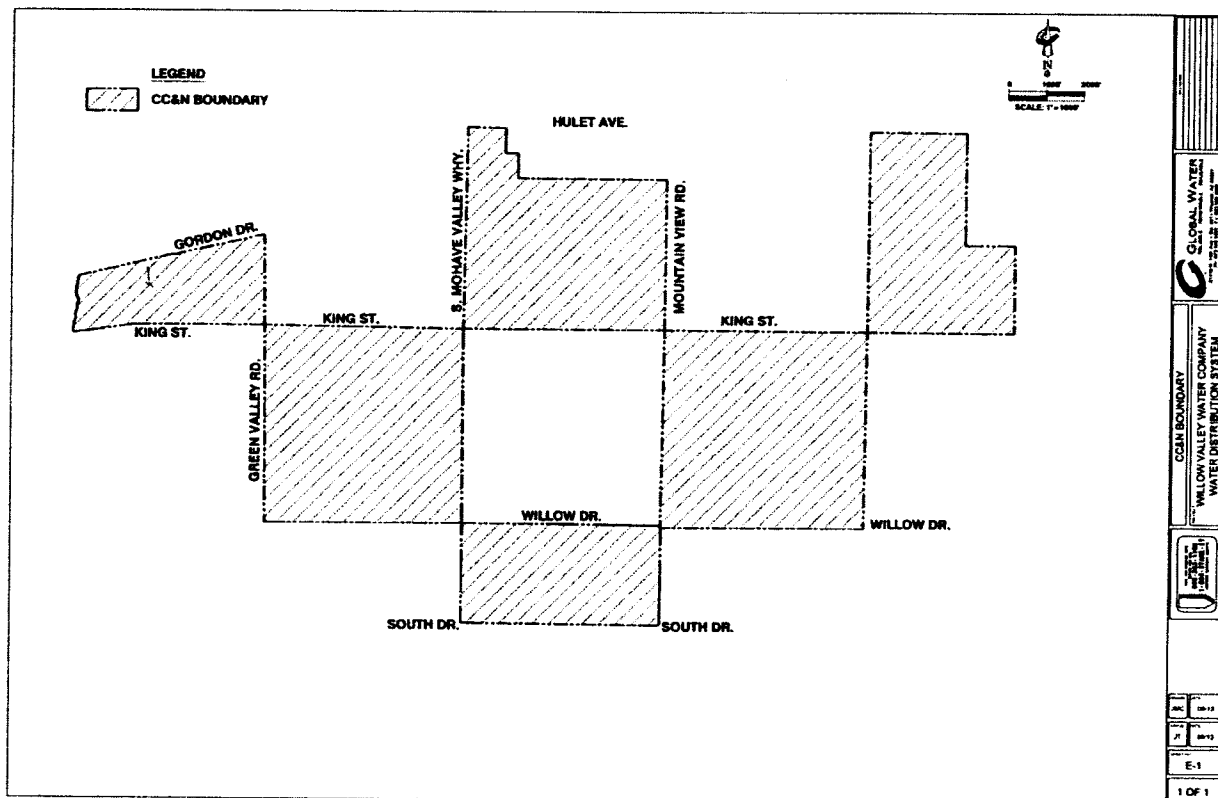


EXHIBIT B

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

W-01732A

Willow Valley Water Company, Inc.
c/o Global Water Resources, Inc.
21410 N. 19th Ave., Ste. 220
Phoenix, AZ 85027

☐ Please click here if pre-printed Company name on this form is not your current Company name or dba name is not included.

Please list current Company name including dba here:

ANNUAL REPORT
Water

FOR YEAR ENDING

12	31	2014
----	----	------

FOR COMMISSION USE

ANN 04	14
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COMPANY INFORMATION

Company Name (Business Name) Willow Valley Water Co., Inc.

Mailing Address 21410 N 19th Avenue, Suite 220

Phoenix
(City)

(Street)

AZ
(State)

85027
(Zip)

623-580-9600

844-233-3517

Telephone No. (Include Area Code)

Fax No. (Include Area Code)

Cell No. (Include Area Code)

Email Address jon.corwin@gwresources.com

Local Office Mailing Address _____

Same as above

(Street)

(City)

(State)

(Zip)

623-518-4000

866-940-1102

Local Customer Service Phone No. (Include Area Code)

(1-800 or other long distance Customer Service Phone No.)

Email Address _____

Website address www.gwresources.com

MANAGEMENT INFORMATION

☐ **Regulatory Contact:** Joanne Ellsworth

☐ **Management Contact:** Jon Corwin

(Name)

General Manager

(Title)

21410 N. 19th Avenue, Suite 220
(Street)

Phoenix
(City)

AZ
(State)

85027
(Zip)

623-580-9600

844-232-3517

Telephone No. (Include Area Code)

Fax No. (Include Area Code)

Cell No. (Include Area Code)

Email Address joncorwin@gwresources.com

On Site Manager: Jon Corwin, General Manager

(Name)

210 E. Coronado Street
(Street)

Buckeye
(City)

AZ
(State)

85027
(Zip)

520-233-2906

520-568-6367

Telephone No. (Include Area Code)

Fax No. (Include Area Code)

Cell No. (Include Area Code)

Email Address jon.corwin@gwresources.com

Statutory Agent: Mike Liebman
(Name)

21410 N. 19th Avenue, Suite 220 Phoenix AZ 85027
(Street) (City) (State) (Zip)

623-580-9600 844-232-3517
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Attorney: Tim Sabo, Snell & Wilmer
(Name)

400 E. Van Buren, Ste. 1900 Phoenix AZ 85004
(Street) (City) (State) (Zip)

602-382-6359 602-382-6070
Telephone No. (Include Area Code) Fax No. (Include Area Code) Cell No. (Include Area Code)

Email Address tsabo@swlaw.com

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- | | |
|---|--|
| <input type="checkbox"/> Sole Proprietor (S) | <input checked="" type="checkbox"/> C Corporation (C) (Other than Association/Co-op) |
| <input type="checkbox"/> Partnership (P) | <input type="checkbox"/> Subchapter S Corporation (Z) |
| <input type="checkbox"/> Bankruptcy (B) | <input type="checkbox"/> Association/Co-op (A) |
| <input type="checkbox"/> Receivership (R) | <input type="checkbox"/> Limited Liability Company |
| <input type="checkbox"/> Other (Describe) _____ | |

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

- | | | |
|-------------------------------------|-----------------------------------|--|
| <input type="checkbox"/> APACHE | <input type="checkbox"/> COCHISE | <input type="checkbox"/> COCONINO |
| <input type="checkbox"/> GILA | <input type="checkbox"/> GRAHAM | <input type="checkbox"/> GREENLEE |
| <input type="checkbox"/> LA PAZ | <input type="checkbox"/> MARICOPA | <input checked="" type="checkbox"/> MOHAVE |
| <input type="checkbox"/> NAVAJO | <input type="checkbox"/> PIMA | <input type="checkbox"/> PINAL |
| <input type="checkbox"/> SANTA CRUZ | <input type="checkbox"/> YAVAPAI | <input type="checkbox"/> YUMA |
| <input type="checkbox"/> STATEWIDE | | |

COMPANY NAME WILLOW VALLEY WATER CO., INC.

UTILITY PLANT IN SERVICE

Acct. No.	DESCRIPTION	Original Cost (OC)	Accumulated Depreciation (AD)	O.C.L.D. (OC less AD)
301	Organization	-	-	-
302	Franchises	-	-	-
303	Land and Land Rights	18,293	-	18,293
304	Structures and Improvements	470,183	153,571	316,612
307	Wells and Springs	1,652,271	395,983	1,256,288
309	Raw Water Supply Mains	5,441	517	4,924
310	Power Generation Equipment	10,751	4,109	6,642
311	Pumping Equipment	574,268	510,843	63,425
320	Water Treatment Equipment	581,773	369,994	211,779
330	Distribution Reservoirs and Standpipes	265,900	138,248	127,652
331	Transmission and Distribution Mains	719,813	290,940	428,873
333	Services	96,681	66,510	30,171
334	Meters and Meter Installations	533,997	318,918	215,079
335	Hydrants	51,038	18,831	32,207
336	Backflow Prevention Devices	1,024	507	517
339	Other Plant and Misc. Equipment	9,272	4,496	4,776
340	Office Furniture and Equipment	15,624	11,452	4,172
341	Transportation Equipment	41,504	41,504	-
343	Tools, Shop and Garage Equipment	37,834	17,123	20,711
344	Laboratory Equipment	9,508	6,761	2,747
345	Power Operated Equipment	41,249	16,588	24,661
346	Communication Equipment	8,211	4,601	3,610
347	Miscellaneous Equipment	10,443	7,492	2,951
348	Other Tangible Plant	13,910	4,355	9,555
	TOTALS	5,168,988	2,383,343	2,785,645

This amount goes on the Balance Sheet Acct. No. 108

COMPANY NAME WILLOW VALLEY WATER CO., INC.

WATER UTILITY CALCULATION OF DEPRECIATION EXPENSE FOR CURRENT YEAR

Acct. No.	DESCRIPTION	Original Cost (1)	Depreciation Percentage (2)	Depreciation Expense (1 x 2)
301	Organization	-	-	-
302	Franchises	-	-	-
303	Land and Land Rights	18,293	0%	-
304	Structures and Improvements	470,183	3.33%	15,149
307	Wells and Springs	1,652,271	3.33%	54,506
309	Raw Water Supply Mains	5,441	2%	109
310	Power Generation Equipment	10,751	5%	535
311	Pumping Equipment	574,268	12.5%	32,372
320	Water Treatment Equipment	581,773	3%	64,415
330	Distribution Reservoirs and Standpipes	265,900	2.22 or 5%	5,412
331	Transmission and Distribution Mains	719,813	2%	13,094
333	Services	96,681	3.33%	3,119
334	Meters and Meter Installations	533,997	8.33%	32,238
335	Hydrants	51,038	2%	932
336	Backflow Prevention Devices	1,024	6.67%	68
339	Other Plant and Misc. Equipment	9,272	6.67%	618
340	Office Furniture and Equipment	15,624	6.67 or 33.33%	1,076
341	Transportation Equipment	41,504	20%	68
343	Tools, Shop and Garage Equipment	37,834	5%	1,848
344	Laboratory Equipment	9,508	10%	918
345	Power Operated Equipment	41,249	5%	2,197
346	Communication Equipment	8,211	10%	804
347	Miscellaneous Equipment	10,443	10%	

				1,045
348	Other Tangible Plant	13,910	10%	1,342
	SUBTOTAL	5,168,988		231,863
	LESS CIAC Amortization			(\$34,150)
	TOTALS *	5,168,988		197,713

*This amount goes on the Comparative Statement of Income and Expense Acct. No. 403

WATER UTILITY BALANCE SHEET

Acct No.		BALANCE AT BEGINNING OF YEAR	BALANCE AT END OF YEAR
	ASSETS		
	CURRENT AND ACCRUED ASSETS		
131	Cash	4,741	9,186
134	Working Funds	0	0
135	Temporary Cash Investments	0	0
141	Customer Accounts Receivable	13,815	15,941
143	Accumulated Provision for Uncollectible Accounts	-1,710	-2,008
146	Notes/Receivables from Associated Companies	0	0
151	Plant Material and Supplies	9,183	0
162	Prepayments	3,807	584
173	Accrued Utility Revenues	50,229	47,369
174	Miscellaneous Current and Accrued Assets	7,560	1,610
	TOTAL CURRENT AND ACCRUED ASSETS	\$87,624	\$72,683
	FIXED ASSETS		
101	Utility Plant in Service	5,151,346	5,168,988
103	Property Held for Future Use	0	0
105	Construction Work in Progress	5,873	19,767
108	Accumulated Depreciation – Utility Plant	-2,135,306	-2,384,123
121	Non-Utility Property	0	0
122	Accumulated Depreciation – Non Utility	0	0
	TOTAL FIXED ASSETS	\$3,021,913	\$2,804,632
	Other Assets		
114	Utility Plant Acquisition Adjustments	398,499	398,499
181	Unamortized Debt Discount & Expense	0	0
190	Accumulated Deferred Income Taxes	0	583,162
	TOTAL OTHER ASSETS	\$398,499	\$981,660
	TOTAL ASSETS	\$3,508,036	\$3,858,975

NOTE: The Assets on this page should be equal to **Total Liabilities and Capital** on the following page.

COMPANY NAME WILLOW VALLEY WATER CO., INC.

WATER UTILITY BALANCE SHEET (CONTINUED)

Acct. No.		BALANCE AT BEGINNING OF YEAR	BALANCE AT END OF YEAR
	LIABILITIES		
	CURRENT LIABILITIES		
231	Accounts Payable	\$26,622	\$17,421
232	Notes Payable (Current Portion)	0	0
234	Notes/Accounts Payable to Associated Companies	0	32,579
235	Customer Deposits	41,297	31,898
236	Accrued Taxes	15,372	16,785
237	Accrued Interest	4,682	4,658
241	Miscellaneous Current and Accrued Liabilities	29,852	51,509
	TOTAL CURRENT LIABILITIES	\$117,824	\$154,850
	LONG-TERM DEBT (Over 12 Months)		
224	Long-Term Notes and Bonds	0	0
	DEFERRED CREDITS		
251	Unamortized Premium on Debt	0	0
252	Advances in Aid of Construction	97,478	69,347
255	Accumulated Deferred Investment Tax Credits	0	0
271	Contributions in Aid of Construction	511,808	537,430
272	Less: Amortization of Contributions	-44,282	-78,432
281	Accumulated Deferred Income Tax	0	0
	TOTAL DEFERRED CREDITS	565,003	528,346
	TOTAL LIABILITIES	\$682,828	\$683,196
	CAPITAL ACCOUNTS		
201	Common Stock Issued	0	0
211	Paid in Capital in Excess of Par Value	3,931,959	4,037,387
215	Retained Earnings	-1,106,751	-861,608
218	Proprietary Capital (Sole Props and Partnerships)	0	0
	TOTAL CAPITAL	\$2,825,208	\$3,175,779
	TOTAL LIABILITIES AND CAPITAL	\$3,508,036	\$3,858,975

WATER UTILITY COMPARATIVE STATEMENT OF INCOME AND EXPENSE

Acct. No.	OPERATING REVENUES	PRIOR YEAR	CURRENT YEAR
461	Metered Water Revenue	\$625,208	630,414
460	Unmetered Water Revenue	\$0	0
474	Other Water Revenues	\$11,377	10,077
	TOTAL REVENUES	\$636,585	640,491
	OPERATING EXPENSES		
601	Salaries and Wages	\$323,459	293,585
604	Employee Pension and Benefits	\$2,976	6,809
615	Purchased Power	\$33,972	34,793
616	Fuel for Power Production	\$0	0
618	Chemicals	\$47,678	41,290
620	Repairs and Maintenance	\$28,638	25,697
621	Office Supplies and Expense	\$24,273	28,813
632	Contractual Services – Accounting	\$18,101	29,149
633	Contractual Services – Legal	\$17,059	13,298
634	Contractual Services – Management	\$106,023	138,774
635	Contractual Services – Testing	\$11,151	9,402
636	Contractual Services - Other	\$10,095	9,891
641	Rental of Buildings	\$11,452	2,495
642	Rental Of Equipment	\$0	0
650	Transportation Expenses	\$23,724	17,765
657	Insurance – General Liability	\$10,806	13,177
659	Insurance - Other	\$24,880	31,258
667	Regulatory Commission Expense – Other	\$18,604	110
670	Bad Debt Expense	\$2,308	958
675	Miscellaneous Expense	\$17,371	22,220
403	Depreciation Expense	\$241,979	233,683
403	Depreciation Expense – CIAC	(\$30,288)	(34,150)
408	Taxes Other Than Income	\$2,548	2,487
408.11	Property Taxes	\$32,895	33,515
408.12	Payroll Taxes	\$23,514	21,846
409	Income Tax	\$0	(584,076)
	TOTAL OPERATING EXPENSES	\$1,003,216	392,789
	OPERATING INCOME/(LOSS)	(\$366,631)	247,702
	OTHER INCOME/(EXPENSE)		
427	Interest Expense	(\$3,637)	(2,559)
	TOTAL OTHER INCOME/(EXPENSE)	(\$3,637)	(2,559)
	NET INCOME/(LOSS)	(\$370,268)	\$245,143

COMPANY NAME WILLOW VALLEY WATER CO., INC.

SUPPLEMENTAL FINANCIAL DATA
Long-Term Debt

	LOAN #1	LOAN #2	LOAN #3	LOAN #4
Date Issued				
Source of Loan				
ACC Decision No.				
Reason for Loan				
Dollar Amount Issued	\$	\$	\$	\$
Amount Outstanding	\$	\$	\$	\$
Date of Maturity				
Interest Rate	%	%	%	%
Current Year Interest	\$	\$	\$	\$
Current Year Principle	\$	\$	\$	\$

Meter Deposit Balance at Test Year End

\$31,898

Meter Deposits Refunded During the Test Year

\$24,670

COMPANY NAME WILLOW VALLEY WATER CO., INC.

Name of System: Lake Cimarron

ADEQ Public Water System Number: AZ-04-08-129

WATER UTILITY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
55-604160	7.5	190	60	12	4"	1960
55-604161	10	225	100	6		1967

* Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
20	2	19	
25	2		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
196,000 GAL	1	5,800 GAL	1

Note: If you are filing for more than one system, please provide separate sheets for each system.

COMPANY NAME WILLOW VALLEY WATER CO., INC.

Name of System: Lake Cimarron

ADEQ Public Water System Number: AZ-04-08-129

WATER UTILITY PLANT DESCRIPTION (CONTINUED)

MAINS

Size (in inches)	Material	Length (in feet)
6	PVC	186
8	PVC	7,347
10	PVC	5,509
UNK	UNK	894
4	UNK	213
6	UNK	684
8	UNK	4,431
10	UNK	548

CUSTOMER METERS

Size (in inches)	Quantity
5/8 x 3/4	130
3/4	2
2	1

For the following three items, list the utility owned assets in each category for each system.

TREATMENT EQUIPMENT:

Chlorine Dioxide Injection System

Sodium Permanganate Injection System

Chlorine Gas Injection System

Fe & Mn Removal System

STRUCTURES:

Treatment Chemicals Storage Shed

Block fences around well sites and distribution center

OTHER:

Note: If you are filing for more than one system, please provide separate sheets for each system.

COMPANY NAME: WILLOW VALLEY WATER CO., INC.

Name of System: Lake Cimarron

ADEQ Public Water System Number: AZ-04-08-129

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	GALLONS SOLD (Thousands)	GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)
JANUARY	130	504	756	
FEBRUARY	130	553	624	
MARCH	130	530	762	
APRIL	130	2,134	785	
MAY	129	629	783	
JUNE	129	747	803	
JULY	129	753	778	
AUGUST	129	690	700	
SEPTEMBER	129	809	554	
OCTOBER	130	690	498	
NOVEMBER	130	648	583	
DECEMBER	129	581	655	
TOTALS →		9,268	8,281	

What is the level of arsenic for each well on your system? 0.005 mg/l

If system has fire hydrants, what is the fire flow requirement? ____ GPM for ____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?

☒ Yes ☐ No

Is the Water Utility located in an ADWR Active Management Area (AMA)?

☐ Yes ☒ No

Does the Company have an ADWR Gallons Per Capita Per Day (GPCPD) requirement?

☐ Yes ☒ No

If yes, provide the GPCPD amount: _____

Note: If you are filing for more than one system, please provide separate data sheets for each system.

COMPANY NAME WILLOW VALLEY WATER CO., INC.

Name of System: King Street

ADEQ Public Water System Number: AZ-04-08-040

WATER UTILITY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
55-208170 Unit 17 - Primary	30	500	120	9	6"	1970
55-603946 Center Street			100	8		1964
55-603947 King Street	15	300	120	8	4"	1959
55-603948 Meadowlark			100	8		1966
55-603949 Unit 17 - Secondary	15	300	100	8	4"	1969
55-603950 Commercial Well			100	8		1965
55-603951 Unit 1	15	250	100	24	4"	1960
55-603952 Riding Club Well			120	20		1960

* Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
15	6	45	
30	1		
40	1		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
163,000 GAL	1	14,000 GAL	1
47,000 GAL	1	2,200 GAL	1
96,000 GAL	1	5,200 GAL	1

Note: If you are filing for more than one system, please provide separate sheets for each system.

COMPANY NAME WILLOW VALLEY WATER CO., INC.

Name of System: King Street

ADEQ Public Water System Number: AZ-04-08-040

WATER UTILITY PLANT DESCRIPTION (CONTINUED)

MAINS

Size (in inches)	Material	Length (in feet)
4	ABS	1,225
6	AC	2,164
2	ASWP	261
4	ASWP	7,412
6	DIP	154
2	PVC	3,802
3	PVC	1,694
4	PVC	52,790
6	PVC	26,277
8	PVC	4,301
4	STEEL	34
8	STEEL	43
UNK	UNK	242
4	UNK	2,479
6	UNK	446
8	UNK	20

CUSTOMER METERS

Size (in inches)	Quantity
5/8 x 3/4	1,459
3/4	10
1	15
2	3
4	2
6	3

For the following three items, list the utility owned assets in each category for each system.

TREATMENT EQUIPMENT:

Chlorine Dioxide Injection System at Unit 17

Sodium Permanganate Injection System at Unit 17

Chlorine Gas Injection System at Unit 17

Fe & Mn Removal System at Unit 17

STRUCTURES:

Office Building

Fences around well sites

Sheds at Unit 17 and King St

OTHER:

1 x Mini-Excavator

1 x Bobcat

3 x Pick-Up Trucks

Note: If you are filing for more than one system, please provide separate sheets for each system.

COMPANY NAME: WILLOW VALLEY WATER CO., INC.

Name of System: King Street

ADEQ Public Water System Number: AZ-04-08-040

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	GALLONS SOLD (Thousands)	GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)
JANUARY	1366	3,591	4,763	
FEBRUARY	1370	3,401	4,363	
MARCH	1371	3,371	5,426	
APRIL	1380	3,798	5,835	
MAY	1375	4,297	6,657	
JUNE	1380	5,224	7,316	
JULY	1379	5,390	8,576	
AUGUST	1379	6,006	7,738	
SEPTEMBER	1372	5,604	6,214	
OCTOBER	1371	4,563	5,909	
NOVEMBER	1373	4,238	6,562	
DECEMBER	1376	3,854	7,043	
TOTALS →		53,335	76,402	

What is the level of arsenic for each well on your system? _____mg/l

ADWR #55-603949 (Unit 17) - 0.0018

If system has fire hydrants, what is the fire flow requirement? ____GPM for ____hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?

(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?

() Yes (X) No

Does the Company have an ADWR Gallons Per Capita Per Day (GPCPD) requirement?

() Yes (X) No

If yes, provide the GPCPD amount:_____

Note: If you are filing for more than one system, please provide separate data sheets for each system.

COMPANY NAME: WILLOW VALLEY WATER CO., INC.

Name of System: Consolidated

ADEQ Public Water System Number: N/A

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY	0	9	
FEBRUARY	0	20	
MARCH	0	10	
APRIL	0	18	
MAY	0	10	
JUNE	0	8	
JULY	0	7	
AUGUST	0	2	
SEPTEMBER	0	13	
OCTOBER	0	11	
NOVEMBER	0	9	
DECEMBER	0	8	
TOTALS →	0	125	

OTHER (description):

WILLOW VALLEY WATER CO., INC.
YEAR ENDING 12/31/2014

PROPERTY TAXES

Amount of actual property taxes paid during Calendar Year 2014 was: \$32,103.37

Attach to this annual report proof (e.g. property tax bills stamped "paid in full" or copies of cancelled checks for property tax payments) of any and all property taxes paid during the calendar year.

If no property taxes paid, explain why. _____

**VERIFICATION
AND
SWORN STATEMENT**
Taxes

VERIFICATION
STATE OF ARIZONA
I, THE UNDERSIGNED
OF THE

COUNTY OF MARICOPA
JON CORWIN, GENERAL MANAGER
WILLOW VALLEY WATER CO., INC.

DO SAY THAT THIS ANNUAL UTILITY PROPERTY TAX AND SALES TAX REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING


MONTH	DAY	YEAR
12	31	2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

I HEREBY ATTEST THAT ALL PROPERTY TAXES FOR SAID COMPANY ARE CURRENT AND PAID IN FULL.

I HEREBY ATTEST THAT ALL SALES TAXES FOR SAID COMPANY ARE CURRENT AND PAID IN FULL.



SIGNATURE OF OWNER OR OFFICIAL
623-580-9600

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

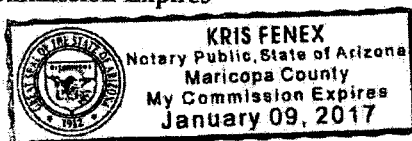
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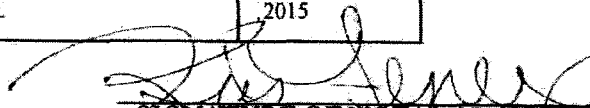
15th

DAY OF

MARICOPA	
APRIL	2015

My Commission Expires





SIGNATURE OF NOTARY PUBLIC

**VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only**

VERIFICATION

STATE OF _____
I, THE UNDERSIGNED
OF THE

COUNTY OF MARICOPA
JON CORWIN, GENERAL MANAGER
WILLOW VALLEY WATER CO., INC.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT


IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2014 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$)

\$675,544

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 35,054
IN SALES TAXES BILLED, OR COLLECTED)

****REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED OR COLLECTED. IF FOR ANY OTHER REASON, THE REVENUE REPORTED ABOVE DOES NOT AGREE WITH TOTAL OPERATING REVENUES ELSEWHERE REPORTED, ATTACH THOSE STATEMENTS THAT RECONCILE THE DIFFERENCE. (EXPLAIN IN DETAIL)**



SIGNATURE OF OWNER OR OFFICIAL
623-580-9600

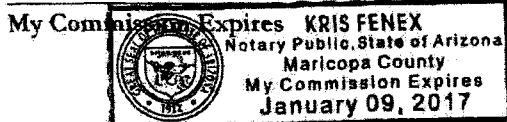
TELEPHONE NUMBER

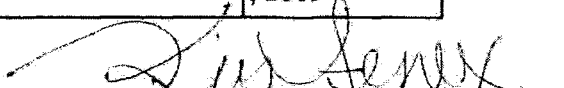
SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS 15th DAY OF

MARICOPA
APRIL, 2015





SIGNATURE OF NOTARY PUBLIC

**VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY**

VERIFICATION
STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF MARICOPA	
JON CORWIN	GENERAL MANAGER
WILLOW VALLEY WATER CO., INC.	

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION
FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2014 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES
<u>\$563,707</u>

(THE AMOUNT IN BOX AT LEFT
INCLUDES \$ 29,694
IN SALES TAXES BILLED, OR COLLECTED

*RESIDENTIAL REVENUE REPORTED ON THIS PAGE
MUST INCLUDE SALES TAXES BILLED.

Jon Corwin
SIGNATURE OF OWNER OR OFFICIAL
674-582-9600
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

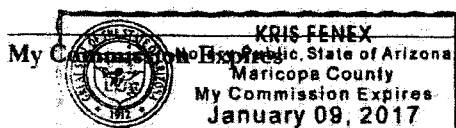
THIS

15th

DAY OF

(SEAL)

KRIS FENEX	
MARICOPA	
APRIL	2015



Kris Fenex
SIGNATURE OF NOTARY PUBLIC

REF. NO.	INVOICE NO.	INVOICE DATE	INVOICE AMOUNT	AMOUNT PAID	DISCOUNT TAKEN	NET CHECK AMOUNT
222422 R0254514/0315		2/1/2015	16,757.49	16,757.49	0.00	16,757.49

WARNING - THIS CHECK IS PROTECTED BY SPECIAL SECURITY GUARD PROGRAM™ FEATURES

Willow Valley Water Company
21410 N 19th Avenue, Suite 220
Phoenix, AZ 85027
(623) 580-9600

WELLS FARGO BANK, N.A.
115 Hospital Drive
Van Wert, OH 45891

56-382/412

007693

DATE	CHECK NO.	AMOUNT
3/3/2015	007693	\$*****16,757.49

PAY Sixteen Thousand Seven Hundred Fifty-Seven and 49/100----- Dollars

TO THE
ORDER
OF

Mohave County Treasurer
PO BOX 712
Kingman, AZ 86402-0712



THIS CHECK CONTAINS MULTIPLE SECURITY FEATURES - SEE BACK FOR DETAILS

Vendor MOHTRE

Check Date 3/3/2015

Check Number 007693

Ref Nbr	Inv Nbr	Inv Date	Invoice Amount	Amount Paid	Disc Taken	Net Check Amt
222422 R0254514/0315		2/1/2015	16,757.49	16,757.49 ✓	0.00	16,757.49

EXHIBIT C

STATE OF ARIZONA



Office of the CORPORATION COMMISSION

CERTIFICATE OF GOOD STANDING

To all to whom these presents shall come, greeting:

I, Jodi A. Jerich, Executive Director of the Arizona Corporation Commission, do hereby certify that

*****WILLOW VALLEY WATER CO., INC.*****

a domestic corporation organized under the laws of the State of Arizona, did incorporate on June 2, 1960.

I further certify that according to the records of the Arizona Corporation Commission, as of the date set forth hereunder, the said corporation is not administratively dissolved for failure to comply with the provisions of the Arizona Business Corporation Act; and that its most recent Annual Report, subject to the provisions of A.R.S. sections 10-122, 10-123, 10-125 & 10-1622, has been delivered to the Arizona Corporation Commission for filing; and that the said corporation has not filed Articles of Dissolution as of the date of this certificate.

This certificate relates only to the legal existence of the above named entity as of the date issued. This certificate is not to be construed as an endorsement, recommendation, or notice of approval of the entity's condition or business activities and practices.

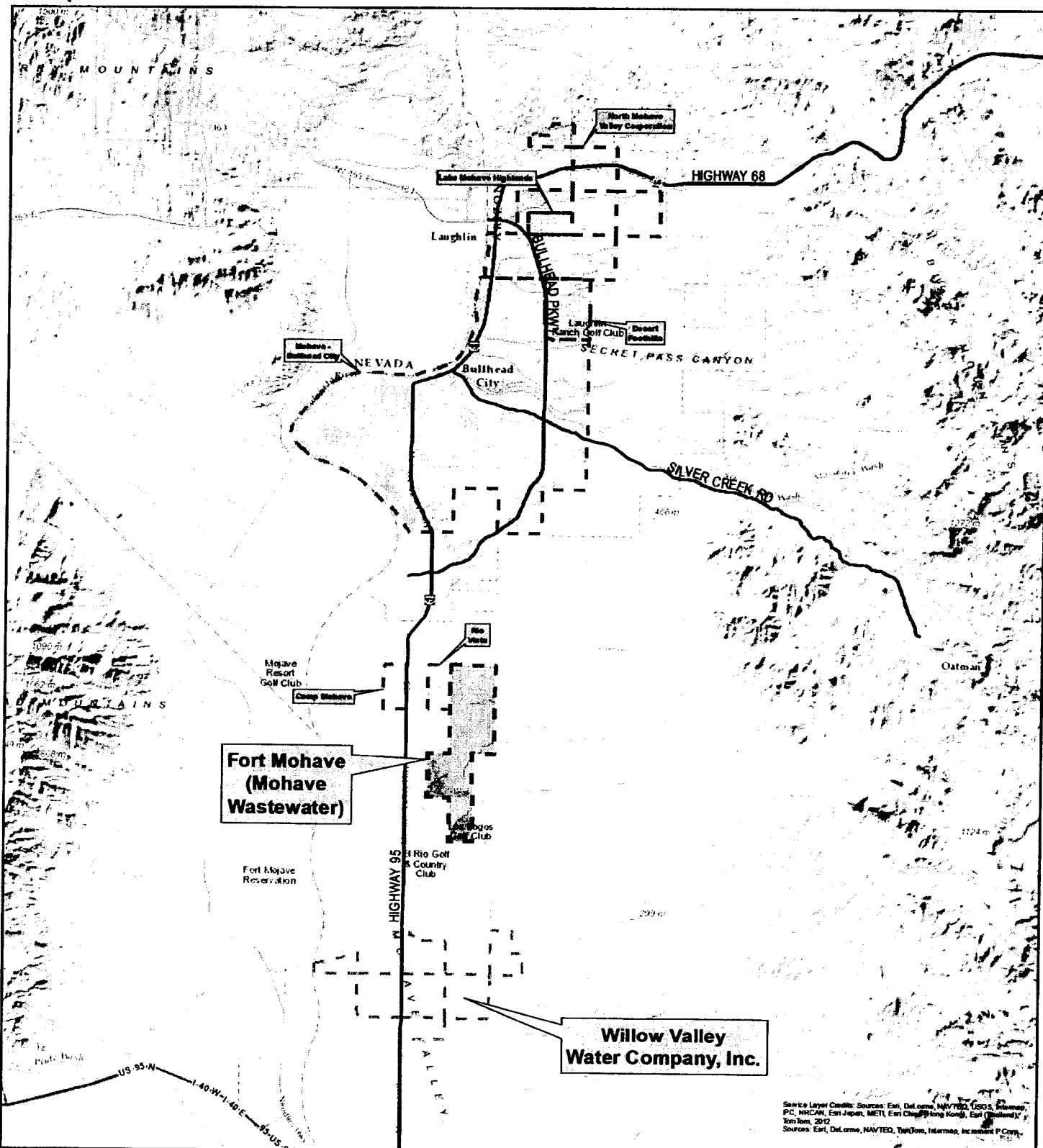
IN WITNESS WHEREOF, I have hereunto set my hand and affixed the official seal of the Arizona Corporation Commission. Done at Phoenix, the Capital, this 20th Day of April, 2015, A. D.



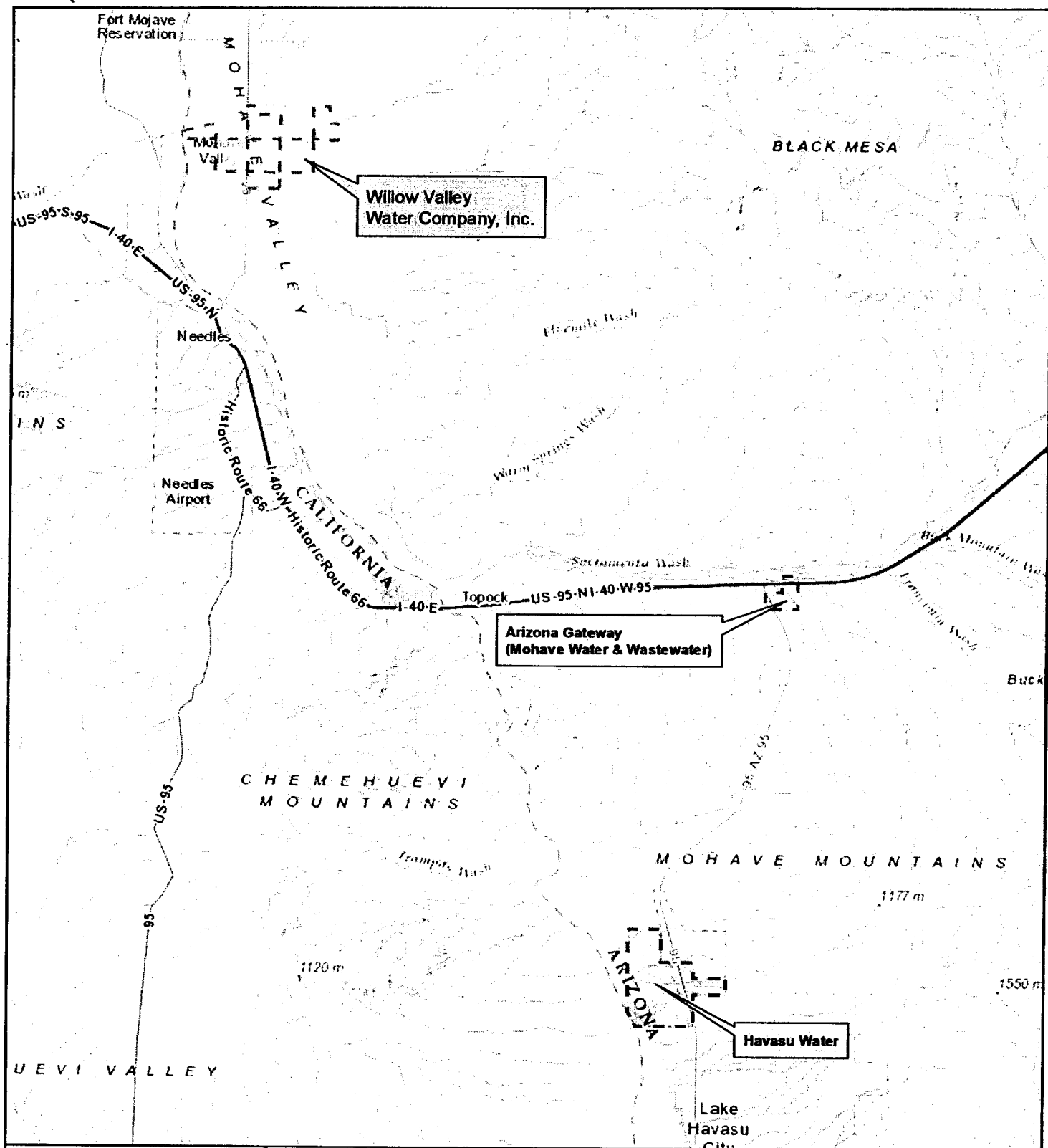

Jodi A. Jerich, Executive Director

By: 1219607

EXHIBIT D



Service Layer Credits: Sources: Esri, DeLorme, NAVTEQ, USGS, Intermap, P.C., NRCAN, Esri Japan, METI, Esri China (Hong Kong), Esri (Thailand), Swisstopo, 2012
 Sources: Esri, DeLorme, NAVTEQ, Swisstopo, Intermap, increment P Corp.



Created: 21 April, 2015

Prepared by: C Martinez




File name: Havasu_WillowCCN.mxd

Data source: EPCOR Water

0 2 4 Miles



Legend:

-  Havasu Water District
-  Arizona Gateway (Mohave Water & Wastewater)
-  Willow Valley Water Company, Inc.

**Havasu Water,
Arizona Gateway
(Mohave Water & Wastewater), &
Willow Valley Service Areas**



2355 W. Pinnacle Peak Rd.
Suite 300
Phoenix, AZ 85027

EXHIBIT E

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL - MAKE CHANGES AS NECESSARY

W-01303A
EPCOR Water Arizona Inc.
2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027



ANNUAL REPORT
Water - Sewer

FOR YEAR ENDING

12 31 2014

FOR COMMISSION USE

ANN 04 12

processed by:

scanned

COMPANY INFORMATION

Company Name (Business Name) <u>EPCOR Water Arizona, Inc. f/k/a Arizona-American Water Company</u>		
Mailing Address <u>2355 W. Pinnacle Peak Road, Suite 300</u>		
<u>Phoenix</u> (City)	<u>AZ</u> (State)	<u>85027</u> (Zip)
<u>(623) 445-2400</u>	<u>(623) 445-2451</u>	<u>N/A</u>
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)
Email Address _____		
Local Office Mailing Address <u>2355 W. Pinnacle Peak Road, Suite 300</u>		
<u>Phoenix</u> (City)	<u>AZ</u> (State)	<u>85027</u> (Zip)
<u>(623) 445-2400</u>	<u>(623) 587-1044</u>	<u>N/A</u>
Local Office Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)
Email Address _____		

MANAGEMENT INFORMATION

Regulatory Contact:		
Management Contact: <u>Sheryl Hubbard</u> <u>Director, Rates</u>		
<u>(Name)</u>	<u>(Title)</u>	
<u>2355 W. Pinnacle Peak Road, Suite 300</u> (Street)	<u>Phoenix</u> (City)	<u>AZ</u> (State)
<u>(623) 445-2420</u>	<u>(623) 587-1044</u>	<u>N/A</u>
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)
Email Address <u>shubbard@epcor.com</u>		
On Site Manager: <u>Sheryl Hubbard</u> <u>Director, Rates</u>		
<u>(Name)</u>	<u>(Title)</u>	
<u>2355 W. Pinnacle Peak Road, Suite 300</u> (Street)	<u>Phoenix</u> (City)	<u>AZ</u> (State)
<u>(623) 445-2420</u>	<u>(623) 587-1044</u>	<u>N/A</u>
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)
Email Address <u>shubbard@epcor.com</u>		

Statutory Agent: <u>Corporate Service Company</u>			
(Name)			
2355 W. Pinnacle Peak Road, Suite 300	Phoenix	AZ	85027
(Street)	(City)	(State)	(Zip)
(624) 445-2400	N/A	N/A	
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)	
Attorney: <u>Martin Stanek</u>			
(Name)			
2355 W. Pinnacle Peak Road, Suite 300	Phoenix	AZ	85027
(Street)	(City)	(State)	(Zip)
(623) 445-2427	N/A	N/A	
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)	

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- | | |
|---|--|
| <input type="checkbox"/> Sole Proprietor (S) | <input checked="" type="checkbox"/> Corporation (C) (Other than Association/Co-op) |
| <input type="checkbox"/> Partnership (P) | <input type="checkbox"/> Subchapter S Corporation (Z) |
| <input type="checkbox"/> Bankruptcy (B) | <input type="checkbox"/> Association/Co Op (A) |
| <input type="checkbox"/> Receivership R | <input type="checkbox"/> Limited Liability Company |
| <input type="checkbox"/> Other (Describe) _____ | |

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

- | | | |
|--|--|--|
| <input type="checkbox"/> APACHE | <input type="checkbox"/> COCHISE | <input type="checkbox"/> COCONINO |
| <input type="checkbox"/> GILA | <input type="checkbox"/> GRAHAM | <input type="checkbox"/> GREENLEE |
| <input type="checkbox"/> LA PAZ | <input checked="" type="checkbox"/> MARICOPA | <input checked="" type="checkbox"/> MOHAVE |
| <input type="checkbox"/> NAVAJO | <input type="checkbox"/> PIMA | <input type="checkbox"/> PINAL |
| <input checked="" type="checkbox"/> SANTA CRUZ | <input type="checkbox"/> YAVAPAI | <input type="checkbox"/> YUMA |
| <input type="checkbox"/> STATEWIDE | | |

COMPANY NAME

Epcor Water Arizona, Inc.

WATER UTILITY PLANT IN SERVICE

Acct. No.	DESCRIPTION	Original Cost (OC)	Accumulated Depreciation (AD)	O.C.L.D. (OC less AD)
301	Organization	68,331	0	68,331
302	Franchises	5,123,396	0	5,123,396
303	Land and Land Rights	11,197,329	111,219	11,086,110
304	Structures and Improvements	96,987,394	16,126,957	80,860,437
305	Collecting and Impounding	1,989,194	516,393	1,472,801
306	Lake, River & Other Intake	1,255,153	258,219	996,933
307	Wells and Springs	34,563,264	9,372,021	25,191,242
308	Infiltration Galleries	245,768	60,645	185,123
309	Supply Mains	3,787,156	283,067	3,504,089
310	Power Production Equipment	5,276,754	1,074,932	4,201,822
311	Pumping Equipment	77,246,480	35,781,190	41,465,290
320	Water Treatment Equipment	71,590,019	30,936,547	40,653,472
330	Distribution Reservoirs and Standpipes	36,306,226	6,580,581	29,745,645
331	Transmission and Distribution Mains	249,583,495	55,166,948	194,416,547
332	Fire Mains	170	66	104
333	Services	44,515,367	14,822,110	29,693,257
334	Meters and Meter Installations	29,062,781	9,098,545	19,964,236
335	Hydrants	23,914,411	6,238,341	17,676,070
336	Backflow Prevention Devices	0	0	0
339	Other Plant and Misc. Equipment	2,121,700	334,160	1,787,540
340	Office Furniture and Equipment	6,367,889	7,641,059	-1,273,169
341	Transportation Equipment	2,739,245	7,078,778	-4,339,533
342	Stores Equipment	30,784	19,349	11,435
343	Tools, Shop and Garage Equipment	1,323,262	544,460	778,802
344	Laboratory Equipment	618,073	151,688	466,385
345	Power Operated Equipment	661,690	388,395	273,295
346	Communication Equipment	10,384,203	5,354,301	5,029,902
347	Miscellaneous Equipment	636,680	65,122	571,558
348	Other Tangible Plant	0	0	0
	Reg Asset AFUDC Debt	1,778	0	1,778
	TOTALS	717,597,992	207,985,093	509,612,899

This amount goes on the Balance Sheet Acct. No. 108

COMPANY NAME

Epcor Water Arizona, Inc.

WATER CALCULATION OF DEPRECIATION EXPENSE FOR CURRENT YEAR

Acct. No.	DESCRIPTION	Original Cost (1)	Depreciation Percentage (2)	Depreciation Expense (1x2)
301	Organization	68,331	*	0
302	Franchises	5,123,398	*	0
303	Land and Land Rights	11,197,329	*	0
304	Structures and Improvements	96,987,394	*	2,406,435
305	Collecting and Impounding	1,989,194	*	48,759
306	Lake, River & Other Intake	1,255,153	*	45,077
307	Wells and Springs	34,563,264	*	870,828
308	Infiltration Galleries and Tunnels	245,768	*	4,915
309	Supply Mains	3,787,156	*	72,826
310	Power Production Equipment	5,278,754	*	257,857
311	Pumping Equipment	77,248,480	*	3,268,294
320	Water Treatment Equipment	71,590,019	*	1,587,574
330	Distribution Reservoirs and Standpipes	36,308,226	*	709,153
331	Transmission and Distribution Mains	249,583,495	*	3,998,199
332	Fire Mains	170	*	3
333	Services	44,515,367	*	1,166,409
334	Meters and Meter Installations	29,062,781	*	1,694,014
335	Hydrants	23,914,411	*	474,504
336	Backflow Prevention Devices	0	*	0
339	Other Plant and Misc. Equipment	2,121,700	*	63,204
340	Office Furniture and Equipment	6,367,889	*	699,238
341	Transportation Equipment	2,739,245	*	460,967
342	Stores Equipment	30,784	*	1,213
343	Tools, Shop and Garage Equipment	1,323,282	*	51,919
344	Laboratory Equipment	618,073	*	30,988
345	Power Operated Equipment	661,890	*	24,651
346	Communication Equipment	10,384,203	*	965,872
347	Miscellaneous Equipment	636,680	*	48,601
348	Other Tangible Plant	0	*	0
	Reg Asset AFUDC Debt	1,778	*	0
	TOTALS	717,597,992	0	18,951,501

* See Attached for depreciation rates

COMPANY NAME

Epcor Water Arizona, Inc.

SEWER UTILITY PLANT IN SERVICE

Acct. No.	DESCRIPTION	Original Cost (OC)	Accumulated Depreciation (AD)	O.C.L.D. (OC less AD)
351	Organization	126,451	-	126,451
352	Franchises	502,925	-	502,925
353	Land and Land Rights	974,694	18,035	956,658
354	Structures and Improvements	26,150,608	7,291,703	18,858,904
355	Power Generation Equipment	1,152,692	225,564	927,129
360	Collection Sewers - Force	6,106,054	1,531,878	4,574,176
361	Collection Sewers - Gravity	81,312,533	26,131,947	55,180,586
362	Special Collecting Structures	3,410,518	4,558,301	-1,147,783
363	Services to Customers	12,471,006	4,570,033	7,900,973
364	Flow Measuring Devices	744,826	443,531	301,295
365	Flow Measuring Installations	-	-	0
370	Receiving Wells	2,126,089	558,041	1,568,048
371	Pumping Equip	4,069,444	1,664,333	2,405,111
380	Treatment and Disposal Equip.	58,580,336	35,711,626	22,868,710
381	Plant Sewer	814,511	360,626	453,886
382	Outfall Sewer Lines	827,477	425,487	401,990
389	Other Plant and Misc. Equipment	1,068,641	566,724	501,917
390	Office Furniture and Equipment	375,028	285,962	89,067
391	Transportation Equipment	243,240	800,329	-557,089
392	Stores Equipment	62,557	12,573	49,984
393	Tools, Shop and Garage Equipment	297,463	145,229	152,234
394	Laboratory Equipment	216,061	81,301	134,761
395	Power Operated Equipment	1,156,541	559,898	596,643
396	Communication Equipment	2,839,601	2,505,926	133,675
397	Misc Equipment	111,315	96,219	15,097
398	Other Tangible Plant	4,029	684	3,345
	TOTALS	205,544,641	88,545,949	116,998,692

This amount goes on the Balance Sheet Acct. No. 108

COMPANY NAME

Epcor Water Arizona, Inc.

SEWER CALCULATION OF DEPRECIATION EXPENSE FOR CURRENT YEAR

Acct. No.	DESCRIPTION	Original Cost (1)	Depreciation Percentage (2)	Depreciation Expense (1x2)
351	Organization	126,451	*	0
352	Franchises	502,925	*	0
353	Land and Land Rights	974,694	*	0
354	Structures and Improvements	26,150,608	*	586,149
355	Power Generation Equipment	1,152,692	*	49,130
360	Collection Sewers - Force	6,106,054	*	124,142
361	Collection Sewers - Gravity	81,312,533	*	1,710,583
362	Special Collecting Structures	3,410,518	*	263,793
363	Services to Customers	12,471,006	*	254,935
364	Flow Measuring Devices	744,826	*	75,643
365	Flow Measuring Installations	0	*	0
370	Receiving Wells	2,126,089	*	70,799
371	Pumping Equip	4,069,444	*	245,032
380	Treatment and Disposal Equip.	58,580,336	*	2,844,854
381	Plant Sewer	814,511	*	40,698
382	Outfall Sewer Lines	827,477	*	41,376
389	Other Plant and Misc. Equipment	1,068,641	*	53,114
390	Office Furniture and Equipment	375,028	*	31,993
391	Transportation Equipment	243,240	*	48,648
392	Stores Equipment	62,557	*	2,477
393	Tools, Shop and Garage Equipment	297,463	*	12,482
394	Laboratory Equipment	216,061	*	15,460
395	Power Operated Equipment	1,156,541	*	58,073
396	Communication Equipment	2,639,801	*	227,673
397	Misc Equipment	111,315	*	5,677
398	Other Tangible Plant	4,029	*	178
	TOTALS	205,544,641	0	6,762,909

This amount goes on the Comparative Statement of Income and Expense Acct. 403

COMPANY NAME

Epcor Water Arizona, Inc.

Sewer Depreciation Rates By Account For Current Year

Acct. No.	DESCRIPTION	Sun City	Sun City West	McHav	Anthem	Agua Fria
351	Organization					
352	Franchisees					
353	Land and Land Rights					
354.2	Structures and Improvements	2.50%	5.00%	2.80%	1.87%	1.87%
354.3	Structures and Improvements-Pumping		5.00%		1.87%	
354.4	Structures and Improvements-Treatment			2.80%	1.87%	1.87%
354.5	Structures and Improvements-General	2.00%	1.87%		1.87%	1.87%
355	Power Generation Equipment	3.33%	3.33%	5.00%	4.42%	4.42%
355.3	WW Pwr Gen Equip SPP	3.33%	3.33%		4.42%	
355.5	Power Generation Equipment-RWTP				4.42%	4.42%
360	Collection Sewers - Force	2.07%	2.07%	2.00%	2.07%	2.07%
361	Collection Sewers - Gravity	2.03%	2.04%	2.00%	2.04%	2.04%
362	Special Collecting Structures	8.40%	8.40%	2.00%	2.04%	8.40%
363	Services to Customers	2.04%	2.04%	2.04%	2.04%	2.04%
364	Flow Measuring Devices	10.00%	10.00%	10.00%	10.00%	10.00%
370	Receiving Wells				3.33%	3.33%
371	Pumping Equipment	5.42%	10.00%	5.42%	5.42%	5.42%
371.2	WW Pump Equip Oth Pwr		10.00%		5.42%	5.42%
380	Treatment and Disposal Equip.		5.00%	1.53%	5.00%	5.00%
380.05	Treatment and Disposal Equip.	2.00%	5.00%	5.00%	5.00%	5.00%
380.1	Treatment and Disposal Equip.	2.00%	5.00%	3.60%	5.00%	5.00%
380.2	Treatment and Disposal Equip.		5.00%		5.00%	5.00%
380.25	Treatment and Disposal Equip.	2.00%	5.00%		5.00%	5.00%
380.3	Treatment and Disposal Equip.		5.00%	5.00%	5.00%	5.00%
380.35	Treatment and Disposal Equip.		5.00%		5.00%	5.00%
380.4	Treatment and Disposal Equip.		5.00%		5.00%	5.00%
380.5	Treatment and Disposal Equip.		5.00%	5.00%	5.00%	5.00%
380.6	Treatment and Disposal Equip.	2.00%	5.00%	5.00%	5.00%	5.00%
380.625	Treatment and Disposal Equip.	2.00%	5.00%	5.00%	5.00%	5.00%
380.65	Treatment and Disposal Equip.	2.00%	5.00%		5.00%	
381	Plant Sewer	5.00%	5.00%		5.00%	5.00%
382	Outfall Sewer Lines	2.00%	5.00%		5.00%	5.00%
388.1	WW Oth Pit & Misc Eqp Intang	4.98%	4.98%		4.98%	4.98%
388.6	Other P/E - CPS	4.98%	4.98%	4.98%		
390	Office Furniture and Equipment	4.59%	4.59%		4.59%	4.59%
390.1	Computer Equipment	4.55%				
390.2	Computers & Peripheral		10.00%	4.04%		
390.3	Computer Software	25.00%	25.00%	25.00%	25.00%	25.00%
391	Transportation Equipment	20.00%	20.00%			
392	Stores Equipment		3.91%		3.96%	3.96%
393	Tools, Shop and Garage Equipment	4.47%	4.47%	4.47%	4.47%	4.47%
394	Laboratory Equipment	10.00%	10.00%	3.71%	3.71%	3.71%
395	Power Operated Equipment		5.02%	5.00%	5.02%	5.02%
396	Communication Equipment	10.28%	10.30%	10.30%	10.30%	10.30%
397	Miscellaneous Equipment	5.10%	5.10%	5.10%	5.10%	
398	Other Tangible Plant	5.10%				10.30%

COMPANY NAME

Epcor Water Arizona, Inc.

BALANCE SHEET

Acct. No.	ASSETS	BALANCE AT BEGINNING OF YEAR	BALANCE AT END OF YEAR
	CURRENT AND ACCRUED ASSETS		
131	Cash	\$ (443,533)	\$ (18,482)
134	Working Funds	1,450	2,850
135	Temporary Cash Investments	-	-
141	Customer Accounts Receivable	5,738,455	4,853,945
146	Notes/Receivables from Associated Companies	-	-
151	Plant Material and Supplies	889,085	648,581
162	Prepayments	1,329,227	1,191,441
174	Miscellaneous Current and Accrued Assets	56,001,210	56,707,390
	TOTAL CURRENT AND ACCRUED ASSETS	\$ 63,513,894	\$ 63,385,745
	FIXED ASSETS		
101	Utility Plant in Service	\$ 874,557,393	\$ 923,142,634
103	Property Held for Future Use	408,640	408,640
105	Construction Work in Progress	22,717,496	18,341,834
108	Accumulated Depreciation - Utility Plant	(265,586,428)	(296,531,042)
121	Non-Utility Property	-	-
122	Accumulated Depreciation - Non Utility	-	-
	TOTAL FIXED ASSETS	\$ 632,097,101	\$ 645,362,065
	TOTAL ASSETS	\$ 695,610,994	\$ 708,747,810

NOTE: The Assets on this page should be equal to Total Liabilities and Capital on the following page

COMPANY NAME

Epcor Water Arizona, Inc.

BALANCE SHEET (CONTINUED)

Acct. No.	LIABILITIES	BALANCE AT BEGINNING OF YEAR	BALANCE AT END OF YEAR
	CURRENT LIABILITIES		
231	Accounts Payable	\$ 5,308,744	\$ 3,547,040
232	Notes Payable (Current Portion)	8,583,003	8,595,703
234	Notes/Accounts Payable to Associated Companies	(29,312,038)	(47,895,848)
235	Customer Deposits	30,020	49,065
236	Accrued Taxes	2,109,411	3,778,504
237	Accrued Interest	435,035	462,095
241	Miscellaneous Current and Accrued Liabilities	12,248,064	18,014,149
	TOTAL CURRENT LIABILITIES	\$ (587,761)	\$ (13,449,291)
	LONG-TERM DEBT (Over 12 Months)		
224	Long-Term Notes and Bonds	\$ 231,711,487	\$ 231,674,441
	DEFERRED CREDITS		
251	Unamortized Premium on Debt	\$ -	\$ -
252	Advances in Aid of Construction	187,811,456	169,026,690
255	Accumulated Deferred Investment Tax Credits	-	-
271	Contributions in Aid of Construction	130,462,696	168,853,420
272	Less: Amortization of Contributions	(30,134,135)	(35,857,635)
281	Accumulated Deferred Income Tax	13,931,911	8,085,287
	TOTAL DEFERRED CREDITS	\$ 302,071,928	\$ 310,107,762
	TOTAL LIABILITIES	\$ 533,195,635	\$ 528,332,912
	CAPITAL ACCOUNTS		
201	Common Stock Issued	\$ 522,880	\$ 522,880
211	Paid in Capital in Excess of Par Value	184,882,920	184,882,920
215	Retained Earnings	(22,990,441)	(4,990,902)
218	Proprietary Capital (Sole Props and Partnerships)	-	-
	TOTAL CAPITAL	\$ 162,415,360	\$ 180,414,898
	TOTAL LIABILITIES AND CAPITAL	\$ 695,610,994	\$ 708,747,810

COMPANY NAME

Epcor Water Arizona, Inc.

WATER COMPARATIVE STATEMENT OF INCOME AND EXPENSE

Acct. No.	OPERATING REVENUES	PRIOR YEAR	CURRENT YEAR
461	Metered Water Revenue	\$ 81,559,405	\$ 85,179,970
460	Unmetered Water Revenue		\$ -
474	Other Water Revenues	\$ 2,302,438	\$ 2,319,885
	TOTAL REVENUES	\$ 83,861,843	\$ 87,499,855
	OPERATING EXPENSES		
601	Salaries and Wages	\$ 10,660,644	\$ 10,667,963
604	Employee Pensions and Benefits	\$ 2,920,352	\$ 2,492,936
610	Purchased Water	\$ 2,483,685	\$ 2,965,197
615	Purchased Power	\$ 6,565,962	\$ 7,044,732
618	Chemicals	\$ 799,981	\$ 862,623
620	Repairs and Maintenance	\$ 1,205,034	\$ 1,235,162
621	Office Supplies and Expense	\$ -	\$ -
630	Outside Services	\$ 7,371,235	\$ 6,836,005
641	Rents	\$ 244,584	\$ 237,456
650	Transportation Expenses	\$ 964,455	\$ 916,495
655	Insurance	\$ 837,541	\$ 972,497
666	Regulatory Commission Expense - Rate Case	\$ 386,978	\$ 222,675
675	Miscellaneous Expense	\$ 4,111,957	\$ 3,628,039
403	Depreciation Expense	\$ 18,214,423	\$ 18,951,501
408	Taxes Other Than Income	\$ 864,551	\$ 933,287
408.11	Property Taxes	\$ 2,816,461	\$ 3,021,151
409	Income Tax	\$ 4,151,614	\$ (764,346)
	TOTAL OPERATING EXPENSES	\$ 64,599,457	\$ 60,223,374
	OPERATING INCOME/(LOSS)	\$ 19,262,386	\$ 27,276,482
	OTHER INCOME/(EXPENSE)		
419	Interest and Dividend Income	\$ -	\$ -
421	Non-Utility Income	\$ 262,771	\$ 341,833
426	Miscellaneous Non-Utility Expenses	\$ (326,270)	\$ (372,574)
427	Interest Expense	\$ (6,693,396)	\$ (6,149,204)
	TOTAL OTHER INCOME/(EXPENSE)	\$ (6,756,896)	\$ (6,179,944)
	NET INCOME/(LOSS)	\$ 12,505,490	\$ 21,096,537

COMPANY NAME

Epcor Water Arizona, Inc.

SEWER COMPARATIVE STATEMENT OF INCOME AND EXPENSE

Acct. No.	OPERATING REVENUES	PRIOR YEAR	CURRENT YEAR
521	Flat Rate Revenues	\$ 29,309,697	\$ 29,960,113
522	Measured Revenues	\$ -	\$ -
536	Other Wastewater Revenues	\$ 35,032	\$ 59,595
	TOTAL REVENUES	\$ 29,344,729	\$ 30,019,708
	OPERATING EXPENSES		
701	Salaries and Wages	\$ 4,003,686	\$ 3,958,023
704	Employee Pensions and Benefits	\$ 910,592	\$ 749,481
710	Purchased Wastewater Treatment	\$ 2,846	\$ 7,420
711	Sludge Removal Expense	\$ 2,973,707	\$ 2,636,060
715	Purchased Power	\$ 1,216,845	\$ 1,191,682
716	Fuel for Power Production	\$ -	\$ -
718	Chemicals	\$ 453,962	\$ 415,101
720	Materials and Supplies	\$ 573,361	\$ 507,494
721	Office Supplies and Expense	\$ -	\$ -
730	Contractual Services	\$ 3,481,648	\$ 3,214,499
741	Rents	\$ 110,803	\$ 110,297
750	Transportation Expenses	\$ 365,635	\$ 335,413
755	Insurance Expense	\$ 219,219	\$ 283,722
766	Regulatory Commission Expense - Rate Case	\$ 99,396	\$ 15,696
775	Miscellaneous Expense	\$ 1,402,729	\$ 1,188,762
403	Depreciation Expense	\$ 6,574,719	\$ 6,762,909
408	Taxes Other Than Income	\$ 322,927	\$ 341,608
408.11	Property Taxes	\$ 1,258,427	\$ 1,267,376
409	Income Tax	\$ 1,992,328	\$ (366,803)
	TOTAL OPERATING EXPENSES	\$ 25,982,830	\$ 22,618,737
	OPERATING INCOME/(LOSS)	\$ 3,381,899	\$ 7,400,971
	OTHER INCOME/(EXPENSE)		
419	Interest and Dividend Income	\$ -	\$ -
421	Non-Utility Income	\$ -	\$ -
426	Miscellaneous Non-Utility Expenses	\$ -	\$ -
427	Interest Expense	\$ (3,240,553)	\$ (3,214,157)
	TOTAL OTHER INCOME/(EXPENSE)	\$ (3,240,553)	\$ (3,214,157)
	NET INCOME/(LOSS)	\$ 141,347	\$ 4,186,813

COMPANY NAME		EPCOR WATER
Name of System: Havasu	ADEQ Public Water System Number:	04-08-015

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled	
55-512988	15	100	420	8	12	1986	Well #8
55-534237	None	None	355	12	6	1992	
55-539646	20	550	150	10	6	1993	
55-594370	20	500	790	16	8	2003	Well #9
55-601829	7.5	50	180	6	None	Unknown	
55-601830	None	None	148	10	None	1968	Well #3
55-601831	15	250	160	8	4	1972	
55-601832	5	75	245	10	3	1970	
55-601833	30	175	150	8	6	1980	

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
5	1		
7.5	1		
15	2		
20	4		
25	4		
30	3		
40	1		
50	5		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
125,000	2	200	1
250,000	1	5,000	1
750,000	1	10,000	1
500,000	1		

COMPANY NAME	EPCOR WATER	
Name of System: Mohave	ADEQ Public Water System Number:	04-08-032

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (Inches)	Year Drilled
55-506309	250	1,400	515	16	6	1983
55-222149	250	1,400	860	21	6	2013
55-509448	75	500	602	14	12	1985
55-519149	100	2,100	280	18	12	1987
55-603472	75	600	610	12-10	8	1975
55-603473	200	2,150	400	14-16	8	1970
55-603477	40	350	450	12	6	1975
55-221762	40	100	1,406	12	3	2013
55-214621	60	180	1,410	8	3	2008

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
1.5	1		
2	1		
7.5	2		
15	7		
20	2		
40	1		
50	5		
100	4		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
35000/36000	1 ea.	70	1
37,500	1	3,000	1
123,000	1	5,000	2
200,000	1	10,000	1
250,000	2		
300,000	1		
424,000	1		
500,000	1		
750,000	1		
1,000,000	3		

COMPANY NAME		EPCOR WATER
Name of System: Camp Mohave	ADEQ Public Water System Number:	04-08-037

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
55-559559	20	500	312	8	4	1996

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
15	2		
40	2		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
250,000	1	5,000	1

COMPANY NAME		EPCOR WATER
Name of System: Lake Mohave	ADEQ Public Water System Number:	04-08-062

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
55-558101	20	150	505	8	4	1996
55-603417	20	150	500	10	4	1973

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
5	2		
10	1		
20	2		
25	2		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
100,000	1	1,000	1
123,000	1	10,000	1
150,000	1		

COMPANY NAME		EPCOR WATER
Name of System: Desert Foothills	ADEQ Public Water System Number:	04-08-137

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (Inches)	Year Drilled
55-557919	150	600	1,073	12	12	1996
55-204657	100	210	985	17	4	2006

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (In thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
10	5		
25	1		
40	1		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
500,000	2	3,000	1
		5,000	1

COMPANY NAME		EPCOR WATER
Name of System: Arizona Gateway	ADEQ Public Water System Number:	04-08-163

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
55-586016	8	35	695	8	2	2003
55-200219	60	300	775	10	6	2007

*Arizona Department of Water Resources Identification Number

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
40	4		

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity
350,000	1	120	3

COMPANY NAME	EPCOR WATER	
Name of System: Rio Vista	ADEQ Public Water System Number:	04-08-333

WATER COMPANY PLANT DESCRIPTION

WELLS

ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (Inches)	Year Drilled

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)
Bermuda Water Company		13,362

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other

STORAGE TANKS		PRESSURE TANKS	
Capacity	Quantity	Capacity	Quantity

COMPANY NAME	EPCOR WATER		
Name of System: North Mohave	ADEQ Public Water System Number:	04-08-068	

WATER COMPANY PLANT DESCRIPTION

WELLS

	ADWR ID Number*	Pump Horsepower	Pump Yield (Gpm)	Casing Depth (Feet)	Casing Diameter (Inches)	Meter Size (inches)	Year Drilled
1	55-608740	30.0	128	380	8	3	1970
2	55-608741	30.0	145	440	8	3	1970
3	55-620581	30.0	125	340	8	3	1975
4	55-507876	30.0	105	588	12	3	1984
7	55-805519	60	100	1,030	8	4	1970
8	55-519603	30	150	300	8	4	1988
9	55-589061	100	440	675	12	6	2001
10	55-211751	100	488	656	12	6	2007

OTHER WATER SOURCES

Name or Description	Capacity (gpm)	Gallons Purchased or Obtained (in thousands)

BOOSTER PUMPS		FIRE HYDRANTS	
Horsepower	Quantity	Quantity Standard	Quantity Other
25	4		
50	2		
20	2		
40	2		

[illegible]

COMPANY NAME	EPCOR WATER	
Name of System: Mohave	ADEQ Public Water System Number:	04-08-032

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS

Size (In Inches)	Material	Length (In feet)
2		13,936
3		73,320
4	PVC	213,060
6	PVC	420,184
8	PVC	218,323
10	PVC	16,907
12	PVC	89,540
16	Various	2,999
18	Various	1,176
24	Various	126
Undetermined		3,184
TOTAL =		1,052,755

CUSTOMER METERS

Size (In Inches)	Quantity
5/8 X 3/4	13,749
3/4	12
1	340
1 1/2	5
2	384
3	17
4	4
6	4
TOTAL	14,515

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

Gas chlorination equipment w/enclosures

STRUCTURES:

Buildings and enclosures associated with wells and booster stations, building utilized as an operations center. Administrative building/office.

OTHER:

COMPANY NAME	EPCOR WATER	
Name of System: Camp Mohave	ADEQ Public Water System Number:	04-08-037

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS

Size (in inches)	Material	Length (in feet)
2	Various	
3	Various	
4	Various	6,975
5	Various	
6	Various	1,665
8	Various	5,185
10	Various	4,429
12	Various	
16	Various	
18	Various	
TOTAL =		18,254

CUSTOMER METERS

Size (in inches)	Quantity
5/8 X 3/4	51
3/4	
1	9
1 1/2	
2	11
3	
4	
6	
TOTAL	71

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

Gas Chlorine, manganese removal plant (ADEGE Package Plant) and associated tanks and structures.

STRUCTURES:

Fencing and associated structures.

OTHER:

COMPANY NAME	EPCOR WATER	
Name of System: Desert Foothills	ADEQ Public Water System Number:	04-08-137

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS

Size (In Inches)	Material	Length (In feet)
2	Various	3
3	Various	
4	Various	
5	Various	
6	Various	17,914
8	Various	71,005
10	Various	2,725
12	Various	14,290
16	Various	
18	Various	
Undetermined		30
TOTAL =		105,967

CUSTOMER METERS

Size (in inches)	Quantity
5/8 X 3/4	1,051
3/4	1
1	8
1 1/2	
2	24
3	
4	1
6	
TOTAL	1,085

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

Chlorine gas and associated equipment

STRUCTURES:

Fencing and associated structures

OTHER:

COMPANY NAME	EPCOR WATER
Name of System: Arizona Gateway	ADEQ Public Water System Number: 04-08-163

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS		
Size (in inches)	Material	Length (in feet)
2		
3		
4		
5		
6	Various	502
8	Various	3,160
10	Various	1,478
12	Various	2,680
16		148
18		
Undetermined	Various	5,316
TOTAL =		13,284

CUSTOMER METERS	
Size (in inches)	Quantity
5/8 X 3/4	5
3/4	
1	
1 1/2	
2	7
3	
4	
6	
TOTAL	12

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

Liquid chlorine and associated equipment.

STRUCTURES:

Structures and buildings associated with water treatment and booster systems.

OTHER:

COMPANY NAME	EPCOR WATER		
Name of System: Rio Vista	ADEQ Public Water System Number:	04-08-333	

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS		
Size (in inches)	Material	Length (in feet)
2		
3		
4		
5		
6	Various	8,985
8	Various	4,359
10	Various	
12	Various	637
16		
18		
	TOTAL =	13,961

CUSTOMER METERS	
Size (In inches)	Quantity
5/8 X 3/4	123
3/4	
1	4
1 1/2	
2	
3	
4	
6	
TOTAL	127

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

N/A

STRUCTURES:

N/A

OTHER:

COMPANY NAME	EPCOR WATER	
Name of System: Mohave	ADEQ Public Water System Number:	04-08-032

WATER COMPANY PLANT DESCRIPTION (CONTINUED)

MAINS*		
Size (in inches)	Material	Length (in feet)
2	Various	2,346
2 1/2	Various	400
3	Various	866
4	Various	35,315
6	Various	60,227
8	Various	55,924
12	Various	60,125
Undetermined	Various	104,921
	TOTAL =	320,124

CUSTOMER METERS*	
Size (in inches)	Quantity
5/8 X 3/4	1,945
3/4	
1	53
1 1/2	35
2	68
3	
4	1
6	
TOTAL	2,102

For the following three items, list the utility owned assets in each category.

TREATMENT EQUIPMENT:

STRUCTURES:

OTHER:

COMPANY NAME	EPCOR WATER
Name of System: Hevasu	ADEQ Public Water System Number: 04-08-015

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A GALLONS PUMPED (Thousands)	B GALLONS PURCHASED (Thousands)	C TOTAL PRODUCTION (Thousands)	D GALLONS AUTHORIZED UNBILLED (Thousands)	E GALLONS SOLD (Thousands)	F TOTAL NRW (Thousands) =C-D-E	G % NON-ACCOUNT WATER (Thousands) =(C-D-E)/C
JANUARY	1,687	17,508		17,508	1,025	14,171	2,312	13.21%
FEBRUARY	1,699	15,691		15,691	771	13,452	1,468	9.36%
MARCH	1,689	17,814		17,814	515	13,277	4,022	22.59%
APRIL	1,674	17,649		17,649	880	14,472	2,297	13.01%
MAY	1,882	19,907		19,907	619	16,788	2,502	12.57%
JUNE	1,880	21,576		21,576	776	16,992	3,808	17.65%
JULY	1,663	20,634		20,634	454	18,826	1,354	6.58%
AUGUST	1,673	22,521		22,521	852	17,255	4,414	19.60%
SEPTEMBER	1,683	20,666		20,666	351	16,687	3,628	17.56%
OCTOBER	1,700	19,590		19,590	806	16,763	2,021	10.32%
NOVEMBER	1,720	17,289		17,289	290	12,226	4,773	27.61%
DECEMBER	1,729	16,740		16,740	735	15,251	754	4.50%
TOTALS ->		227,585	0	227,585	8,074	186,158	33,363	14.66%

What is the level of arsenic for each well on your system. _____ mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? _____ GPM for _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
() Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: _____ N/A

EPCOR Water
Eastern Division - Havasu Water District
Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)												
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	TOTAL
Gallons Pumped													
Water Treatment													0
Wells	17,508	15,691	17,814	17,849	19,907	21,576	20,634	22,521	20,666	19,590	17,289	16,740	227,585
Gallons Purchased													0
Total Production	17,508	15,691	17,814	17,849	19,907	21,576	20,634	22,521	20,666	19,590	17,289	16,740	227,585
Unauthorized Unbilled Consumption													
In-Plant Usage	0	0	0	0	0	0	0	0	0	0	0	0	0
Mixing Chemicals - Field	0	0	0	0	0	0	0	0	0	0	0	0	0
Well Pumped Waste	0	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Mains	1,025	771	515	880	619	776	464	852	351	806	290	735	8,074
Identified Fire Usage	0	0	0	0	0	0	0	0	0	0	0	0	0
Vandalism	0	0	0	0	0	0	0	0	0	0	0	0	0
Street Cleaning	0	0	0	0	0	0	0	0	0	0	0	0	0
Draining Storage Tanks	0	0	0	0	0	0	0	0	0	0	0	0	0
Online Analyzers & Chlorinators	0	0	0	0	0	0	0	0	0	0	0	0	0
Field Meter Testing	0	0	0	0	0	0	0	0	0	0	0	0	0
Fire Hydrant Maintenance	0	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Sewer Mains	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Authorized Unbilled Consumption	1,025	771	515	880	619	776	464	852	351	806	290	735	8,074
Gallons Sold													
Residential	9,437	12,045	11,999	13,014	14,714	15,024	16,600	15,129	14,690	14,801	10,652	13,891	161,996
Commercial	4,734	1,259	1,268	1,447	2,060	1,966	2,214	2,114	1,985	1,949	1,560	1,360	23,906
Industrial											2		2
Fire Service													0
OPA													0
Resale													0
Miscellaneous		148	10	11	12	12	12	12	12	13	12		254
Total Sales	14,171	13,304	13,267	14,472	16,776	16,990	18,814	17,255	16,675	16,750	12,214	15,251	186,956
Non-Billed Sales													
Gallons =C-D-E	2,312	1,488	4,022	2,297	2,502	3,808	1,354	4,414	3,628	2,021	4,773	754	33,353
Percentage =(C-D-E)/C	13.21%	9.36%	22.58%	13.01%	12.57%	17.65%	6.56%	19.60%	17.56%	10.32%	27.61%	4.50%	14.66%

Negative numbers indicate quantity or percentage above production or 100%

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Mohave	ADEQ Public Water System Number: 04-08-032

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A	B	C	D	E	F	G
		GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)	TOTAL PRODUCTION (Thousands)	GALLONS AUTHORIZED UNBILLED (Thousands)	GALLONS SOLD (Thousands)	TOTAL NRW (Thousands)	% NON-ACCOUNT WATER (Thousands)
							=C-D-E	=(C-D-E)/C
JANUARY	14,331	138,396		138,396	4,348	108,171	23,877	17.51%
FEBRUARY	14,368	122,475		122,475	3,985	108,014	10,496	8.57%
MARCH	14,383	140,990		140,990	4,308	133,057	3,625	2.57%
APRIL	14,389	143,689		143,689	4,487	111,026	28,176	19.61%
MAY	14,383	155,968		155,968	5,339	125,541	25,088	16.09%
JUNE	14,372	168,048		168,048	5,495	144,936	17,817	10.48%
JULY	14,356	188,733		188,733	13,770	145,977	9,966	5.88%
AUGUST	14,338	158,587		158,587	12,039	142,796	3,762	2.37%
SEPTEMBER	14,371	148,988		148,988	10,521	128,944	9,523	6.38%
OCTOBER	14,387	146,200		146,200	15,828	118,421	11,951	8.17%
NOVEMBER	14,394	108,766		108,766	11,740	124,189	(27,143)	-24.96%
DECEMBER	14,378	131,877		131,877	8,399	100,590	22,888	17.38%
TOTALS ->		1,731,717	0	1,731,717	100,239	1,491,842	139,636	8.08%

What is the level of arsenic for each well on your system. _____ mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? 1,000 _____ GPM for 2.0 _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: N/A

EPCOR Water
 Eastern Division - Mohave Water District - Bullhead City (08-032)
 Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)											
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
A Gallons Billed												
Water Treatment	0	0	0	0	0	0	0	0	0	0	0	0
Wells	136,396	122,475	140,990	143,689	155,968	168,048	169,733	158,587	148,988	146,200	108,766	131,877
B Gallons Purchased												
Wells	0	0	0	0	0	0	0	0	0	0	0	0
C Total Production	136,396	122,475	140,990	143,689	155,968	168,048	169,733	158,587	148,988	146,200	108,766	131,877
D Authorized Unbilled/Consumption												
In-Plant Usage	0	0	0	0	0	0	0	0	0	14	0	14
Mixing Chemicals - Field	0	0	0	0	0	0	0	0	0	0	0	0
Well Pumped Waste	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Mains	4,348	3,965	4,308	4,487	5,339	5,495	13,770	12,039	10,521	15,814	11,740	8,399
Identified Fire Usage	0	0	0	0	0	0	0	0	0	0	0	0
Vandalism	0	0	0	0	0	0	0	0	0	0	0	0
Street Cleaning	0	0	0	0	0	0	0	0	0	0	0	0
Draining Storage Tanks	0	0	0	0	0	0	0	0	0	0	0	0
Online Analyzers & Chlorinators	0	0	0	0	0	0	0	0	0	0	0	0
Field Meter Testing	0	0	0	0	0	0	0	0	0	0	0	0
Fire Hydrant Maintenance	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Sewer Mains	0	0	0	0	0	0	0	0	0	0	0	0
Total Authorized Unbilled/Consumption	4,348	3,965	4,308	4,487	5,339	5,495	13,770	12,039	10,521	15,814	11,740	8,399
E Gallons Sold												
Residential	81,197	78,882	102,962	82,458	90,825	110,356	108,907	106,753	98,077	89,912	93,336	75,204
Commercial	22,370	23,465	24,743	22,007	26,634	25,414	27,063	27,478	22,773	21,449	22,938	18,609
Industrial	0	0	0	0	0	0	0	0	0	0	0	0
Fire Service	0	0	0	0	0	0	0	0	0	0	0	0
OPA	4,584	5,613	5,141	6,426	7,717	8,995	9,852	8,405	7,948	6,951	7,740	6,396
Resale	0	0	0	0	0	0	0	0	0	0	0	0
Miscellaneous	20	54	211	135	365	171	155	160	146	109	155	381
Total Sales	108,171	108,014	133,057	111,026	125,541	144,936	145,917	142,796	128,954	118,931	122,189	100,590
F Non-Account Water												
Gallons	23,877	10,496	3,625	28,176	25,088	17,617	9,986	3,752	9,523	11,951	(27,143)	22,888
Percentage	17.51%	8.57%	2.57%	19.61%	16.09%	10.48%	5.88%	2.37%	6.39%	8.17%	(24.96%)	17.36%

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Camp Mohave	ADEQ Public Water System Number: 04-08-037

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A GALLONS PUMPED (Thousands)	B GALLONS PURCHASED (Thousands)	C TOTAL PRODUCTION (Thousands)	D GALLONS AUTHORIZED UNBILLED (Thousands)	E GALLONS SOLD (Thousands)	F TOTAL NRW (Thousands) =C-D-E	G NON-ACCOUNT WATER (Thousands) =(C-D-E)/C
JANUARY	69	1,486		1,486	0	1,398	88	5.92%
FEBRUARY	70	1,221		1,221	35	1,327	(141)	-11.55%
MARCH	72	1,152		1,152	1	1,159	(8)	-0.69%
APRIL	72	1,397		1,337	0	1,294	63	3.98%
MAY	74	1,593		1,593	0	1,485	108	6.78%
JUNE	76	1,833		1,833	0	1,756	78	4.28%
JULY	74	1,731		1,731	0	1,787	(56)	-3.24%
AUGUST	74	1,728	2	1,728	0	1,805	(77)	-4.48%
SEPTEMBER	72	1,602		1,602	45	1,840	(83)	-5.18%
OCTOBER	72	1,273		1,273	0	1,368	(95)	-7.48%
NOVEMBER	72	1,019		1,019	0	1,216	(197)	-19.33%
DECEMBER	72	1,197		1,197	0	994	203	16.95%
TOTALS ->		17,170	2	17,172	81	17,218	(127)	-0.74%

What is the level of arsenic for each well on your system. _____ mg/l
(if more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? 1,000 _____ GPM for 2.0 _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: N/A

EPCOR Water

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Lake Mohave	ADEQ Public Water System Number: 04-08-062

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

		A	B	C	D	E	F	G
MONTH	NUMBER OF CUSTOMERS	GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)	TOTAL PRODUCTION (Thousands)	GALLONS AUTHORIZED UNBILLED (Thousands)	GALLONS SOLD (Thousands)	TOTAL NRW (Thousands)	% NON-ACCOUNT WATER (Thousands)
							=C-D-E	=(C-D-E)/C
JANUARY	268	1,722		1,722	0	1,440	282	16.38%
FEBRUARY	269	1,615		1,615	0	1,438	177	10.96%
MARCH	269	1,962		1,952	20	1,334	598	30.64%
APRIL	270	1,999		1,999	0	2,214	(215)	-10.76%
MAY	269	2,352		2,352	0	1,830	722	30.70%
JUNE	269	2,731	450	3,161	693	1,840	648	20.37%
JULY	269	1,348	1,121	2,469	800	1,874	(5)	-0.20%
AUGUST	268	1,182	1,414	2,596	20	2,446	130	5.01%
SEPTEMBER	268	1,057	1,412	2,469	0	2,198	273	11.06%
OCTOBER	267	1,170	1,099	2,269	0	1,810	458	20.23%
NOVEMBER	268	937	1,099	2,036	94	2,013	(71)	-3.49%
DECEMBER	268	895	1,099	1,994	0	1,478	516	25.96%
TOTALS ->		18,960	7,894	26,854	1,427	21,711	3,616	13.19%

What is the level of arsenic for each well on your system. _____ mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? 1,000 _____ GPM for _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
() Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: _____ N/A

Arizona American Water
 Eastern Division - Mohave Water District - Lake Mohave Highlands (08-062)
 Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)											
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
A Gallons Produced												
Water Treatment												
Wells	1,722	1,615	1,952	1,999	2,352	2,731	1,348	1,162	1,057	1,170	937	895
B Gallons Purchased						450	1,121	1,414	1,412	1,099	1,099	1,099
C Total Production	1,722	1,615	1,952	1,999	2,352	3,181	2,469	2,576	2,469	2,269	2,036	1,994

D Authorized Unbilled Consumption												
In-Plant Usage	0	0	0	0	0	0	0	0	0	0	0	0
Mixing Chemicals - Field	0	0	0	0	0	0	0	0	0	0	0	0
Well Pumped Waste	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Mains	0	0	20	0	0	693	600	20	0	0	94	0
Identified Fire Usage	0	0	0	0	0	0	0	0	0	0	0	0
Vandalism	0	0	0	0	0	0	0	0	0	0	0	0
Street Cleaning	0	0	0	0	0	0	0	0	0	0	0	0
Draining Storage Tanks	0	0	0	0	0	0	0	0	0	0	0	0
Online Analyzers & Chlorinators	0	0	0	0	0	0	0	0	0	0	0	0
Field Meter Testing	0	0	0	0	0	0	0	0	0	0	0	0
Fire Hydrant Maintenance	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Sewer Mains	0	0	0	0	0	0	0	0	0	0	0	0
Total Authorized Unbilled Consumption	0	0	20	0	0	693	600	20	0	0	94	0

E Gallons Sold	1,418	1,424	1,317	2,192	1,619	1,815	1,785	2,391	2,143	1,760	1,952	1,434
Residential	22	14	17	22	11	18	28	34	32	33	40	25
Commercial												
Industrial												
Fire Service												
OPA												
Resale												
Miscellaneous						7	61	21	21	17	21	17
Total Sales	1,440	1,438	1,334	2,214	1,630	1,833	1,813	2,415	2,174	1,777	2,013	1,451

F Non-Accounting Water												
=C-D-E	282	177	598	(215)	722	648	(5)	130	273	459	(71)	518
Percentage	16.38%	10.96%	30.64%	(10.76%)	30.70%	20.37%	(0.20%)	5.01%	11.06%	20.23%	(3.49%)	25.88%
												13.19%

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Desert Foothills	ADEQ Public Water System Number: 04-04-137

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A GALLONS PUMPED (Thousands)	B GALLONS PURCHASED (Thousands)	C TOTAL PRODUCTION (Thousands)	D GALLONS AUTHORIZED UNBILLED (Thousands)	E GALLONS SOLD (Thousands)	F TOTAL NRW (Thousands)	G NON-ACCOUNT WATER (Thousands)
							=C-D-E	=(C-D-E)/C
JANUARY	1,064	17,305		17,305	2	15,047	2,256	13.04%
FEBRUARY	1,074	15,191		15,191	223	16,461	(1,493)	-9.83%
MARCH	1,077	13,562		13,562	27	13,863	(128)	-0.94%
APRIL	1,082	18,178		18,178	42	17,414	722	3.97%
MAY	1,080	20,412		20,412	40	17,396	2,976	14.58%
JUNE	1,083	21,832		21,832	7	20,188	1,639	7.51%
JULY	1,083	23,815		23,815	123	21,594	2,098	8.81%
AUGUST	1,085	23,082		23,082	0	20,484	2,618	11.34%
SEPTEMBER	1,083	21,176		21,176	156	20,685	335	1.58%
OCTOBER	1,082	21,371		21,371	20	18,853	2,498	11.69%
NOVEMBER	1,083	17,788		17,788	33	17,981	(206)	-1.16%
DECEMBER	1,085	14,591		14,591	0	14,220	371	2.54%
TOTALS ->		228,303	0	228,303	673	213,944	13,686	5.98%

What is the level of arsenic for each well on your system. _____mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? 1,000 _____ GPM for 2.0 _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: _____ N/A

EPCOR Water
Eastern Division - Mohave Water District - Desert Foothills Estates (08-137)
Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)												
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	TOTAL
A. Gallons Pumped													
Water Treatment													0
Wells	17,305	15,191	13,562	18,178	20,412	21,832	23,815	23,082	21,176	21,371	17,788	14,591	228,303
B. Gallons Purchased													0
C. Total Production	17,305	15,191	13,562	18,178	20,412	21,832	23,815	23,082	21,176	21,371	17,788	14,591	228,303
D. Authorized Unbilled Consumption													
In-Plant Usage	0	0	0	0	0	0	0	0	0	0	0	0	0
Mixing Chemicals - Field	0	0	0	0	0	0	0	0	0	0	0	0	0
Well Pumped Waste	0	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Mains	2	223	27	42	40	7	123	0	156	20	33	0	673
Identified Fire Usage	0	0	0	0	0	0	0	0	0	0	0	0	0
Vandalism	0	0	0	0	0	0	0	0	0	0	0	0	0
Street Cleaning	0	0	0	0	0	0	0	0	0	0	0	0	0
Draining Storage Tanks	0	0	0	0	0	0	0	0	0	0	0	0	0
Online Analyzers & Chlorinators	0	0	0	0	0	0	0	0	0	0	0	0	0
Field Meter Testing	0	0	0	0	0	0	0	0	0	0	0	0	0
Fire Hydrant Maintenance	0	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Sewer Mains	0	0	0	0	0	0	0	0	0	0	0	0	0
E. Total Authorized Unbilled Consumption	2	223	27	42	40	7	123	0	156	20	33	0	673
F. Gallons Sold													
Residential	12,651	13,758	11,306	13,284	14,271	16,440	17,401	16,647	16,700	14,770	14,762	11,668	173,658
Commercial	2,396	2,703	2,357	4,130	3,125	3,746	4,193	3,817	3,985	4,083	3,199	2,552	40,286
Industrial													0
Fire Service													0
OPA													0
Resale													0
Miscellaneous													0
G. Total Sales	15,047	16,461	13,663	17,414	17,396	20,186	21,594	20,464	20,685	18,853	17,961	14,220	223,944
H. Non-Accounting Water													
Gallons =C-D-E	2,256	(1,493)	(128)	722	2,976	1,639	2,098	2,618	335	2,498	(206)	371	13,686
Percentage =(C-D-E)/C	13.04%	(9.83%)	(0.94%)	3.97%	14.58%	7.51%	8.81%	11.34%	1.59%	11.69%	(1.16%)	2.54%	5.99%

Equivalent numbers indicate quantity or percentage above production or 100%

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Arizona Gateway	ADEQ Public Water System Number: 04-08-163

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A GALLONS PUMPED (Thousands)	B GALLONS PURCHASED (Thousands)	C TOTAL PRODUCTION (Thousands)	D GALLONS AUTHORIZED UNBILLED (Thousands)	E GALLONS SOLD (Thousands)	F TOTAL NRW (Thousands)	G NON-ACCOUNT WATER (Thousands)	% NON-ACCOUNT WATER (Thousands)
							=C-D-E	=(C-D-E)/C	
JANUARY	8	444		444	0	359	85		19.13%
FEBRUARY	8	441		441	0	339	102		23.10%
MARCH	8	531		531	0	491	40		7.52%
APRIL	8	572		572	0	699	(127)		-22.17%
MAY	8	589		589	0	531	58		9.87%
JUNE	8	818		818	0	678	138		16.91%
JULY	8	687		687	0	745	(58)		-8.45%
AUGUST	9	837		837	0	649	188		22.42%
SEPTEMBER	8	857		857	0	772	85		9.92%
OCTOBER	9	889		889	0	707	182		20.47%
NOVEMBER	10	1,020		1,020	0	958	62		6.08%
DECEMBER	11	810		810	0	811	(1)		-0.12%
TOTALS ->		8,493	0	8,493	0	7,739	754		8.87%

What is the level of arsenic for each well on your system. _____ mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement? 1,000 _____ GPM for 2.0 _____ hrs

If system has chlorination treatment, does this treatment system chlorinate continuously?
(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gellons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: _____ N/A

EPCOR Water
 Eastern Division - Mohave Water District - AZ Gateway (08-163)
 Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)											
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
A. Gallons Pumped												
Water Treatment												
Wells	444	441	531	572	589	816	687	837	857	889	1,020	810
B. Gallons Purchased												
Wells												
C. Total Production	444	441	531	572	589	816	687	837	857	889	1,020	810
D. Authorized Unbilled Consumption												
In-Plant Usage	0	0	0	0	0	0	0	0	0	0	0	0
Mixing Chemicals - Field	0	0	0	0	0	0	0	0	0	0	0	0
Well Pumped Waste	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Mains	0	0	0	0	0	0	0	0	0	0	0	0
Identified Fire Usage	0	0	0	0	0	0	0	0	0	0	0	0
Vandalism	0	0	0	0	0	0	0	0	0	0	0	0
Street Cleaning	0	0	0	0	0	0	0	0	0	0	0	0
Draining Storage Tanks	0	0	0	0	0	0	0	0	0	0	0	0
Online Analyzers & Chlorinators	0	0	0	0	0	0	0	0	0	0	0	0
Field Meter Testing	0	0	0	0	0	0	0	0	0	0	0	0
Fire Hydrant Maintenance	0	0	0	0	0	0	0	0	0	0	0	0
Flushing Sewer Mains	0	0	0	0	0	0	0	0	0	0	0	0
Total Authorized Unbilled Consumption	0	0	0	0	0	0	0	0	0	0	0	0
E. Gallons Sold												
Residential	359	339	491	699	531	678	745	649	772	707	958	811
Commercial												
Industrial												
Fire Service												
OPA												
Resale												
Miscellaneous												
Total Sales	359	339	491	699	531	678	745	649	772	707	958	811
F. Unaccounted Water												
Gallons	85	102	40	(127)	58	138	(58)	188	85	182	62	(1)
Percentage	19.13%	23.10%	7.52%	(22.17%)	9.87%	16.91%	(8.45%)	22.42%	9.92%	20.47%	6.08%	(0.12%)

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: Rio Vista	ADER Public Water System Number: 04-08-333

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 2014

MONTH	NUMBER OF CUSTOMERS	A	B	C	D	E	F	G
		GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)	TOTAL PRODUCTION (Thousands)	GALLONS AUTHORIZED UNBILLED (Thousands)	GALLONS SOLD (Thousands)	TOTAL NRW (Thousands) =C-D-E	% NON-ACCOUNT WATER (Thousands) =(C-D-E)/C
JANUARY	125		980	980		980	0	0.00%
FEBRUARY	125		852	852		852	0	0.00%
MARCH	126		930	930		930	0	0.00%
APRIL	126		1,088	1,088		1,088	0	0.00%
MAY	125		1,138	1,138		1,138	0	0.00%
JUNE	126		1,400	1,400		1,400	0	0.00%
JULY	124		1,420	1,420		1,420	0	0.00%
AUGUST	123		1,510	1,510		1,510	0	0.00%
SEPTEMBER	125		1,098	1,098		1,098	0	0.00%
OCTOBER	125		985	985		985	0	0.00%
NOVEMBER	126		1,159	1,159		1,159	0	0.00%
DECEMBER	126		824	824		824	0	0.00%
TOTALS ~		0	13,382	13,382	0	13,382	0	0.00%

What is the level of arsenic for each well on your system. _____ mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement?

One and two-family dwellings <= 3,600 sq. ft.: 1,500 gpm for 2 hours
One and two-family dwellings > 3,600 sq. ft.: In accordance with the 1997 UFC
All other development: 3,000 gpm for 3 hours (minimum)

If system has chlorination treatment, does this treatment system chlorinate continuously?
(X) Yes () No

Is the Water Utility located in an ADWR Active Management Area (AMA)?
() Yes (X) No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?
() Yes (X) No

If yes, provide the GPCPD amount: N/A

EPCOR Water
Eastern Division - Mohave Water District - Rio Vista Ranches (08-333)
Unaccounted For Water - 2014

Description	Quantity of Water (Kgal)												TOTAL
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	
Water Treatment													0
Wells													0
Total Production	860	852	830	1,088	1,136	1,400	1,420	1,510	1,098	985	1,158	824	13,362
Authorized Unbilled Consumption													
In-Plant Usage													0
Mixing Chemicals - Field													0
Well Pumped Waste													0
Flushing Mains													0
Identified Fire Usage													0
Vandalism													0
Street Cleaning													0
Draining Storage Tanks													0
Online Analyzers & Chlorinators													0
Field Meter Testing													0
Fire Hydrant Maintenance													0
Flushing Sewer Mains													0
Total Authorized Unbilled Consumption													
Gallons Sold													
Residential	860	852	830	1,088	1,136	1,400	1,420	1,510	1,098	985	1,158	824	13,362
Commercial													0
Industrial													0
Fire Service													0
OPA													0
Retail													0
Miscellaneous													0
Total Gallons Sold	860	852	830	1,088	1,136	1,400	1,420	1,510	1,098	985	1,158	824	13,362
Non-Account Water													
Gallons	=C-D-E	0	0	0	0	0	0	0	0	0	0	0	0
Percentage	=(C-D-E)/C	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Negative numbers indicate quantity or percentage above production or 100%

COMPANY NAME	EPCOR WATER
Name of System: North Mohave	ADEQ Public Water System Number:

WATER USE DATA SHEET BY MONTH FOR CALENDAR YEAR 201

MONTH	NUMBER OF CUSTOMERS	A	B
		GALLONS PUMPED (Thousands)	GALLONS PURCHASED (Thousands)
JANUARY	1,982	26,769	
FEBRUARY	1,983	18,119	
MARCH	1,988	21,805	
APRIL	1,985	22,833	
MAY	1,987	26,701	
JUNE	1,986	28,229	
JULY	1,983	31,537	
AUGUST	1,987	30,095	
SEPTEMBER	1,990	27,662	
OCTOBER	1,999	26,914	
NOVEMBER	2,001	23,540	
DECEMBER	2,000	23,348	
TOTALS ->			0

What is the level of arsenic for each well on your system. _____mg/l
(If more than one well, please list each separately)

If system has fire hydrants, what is the fire flow requirement?

If system has chlorination treatment, does this treatment system chlorinate continuously?

☐ Yes ☐ No

Is the Water Utility located in an ADWR Active Management Area (AMA)?

☐ Yes ☐ No

Does the Company have An ADWR Gallons Per Capita Per Day (GPCPD) requirement?

☐ Yes ☐ No

If yes, provide the GPCPD amount: _____

04-08-068

4

C	D	E	F	G
TOTAL PRODUCTION (Thousands)	GALLONS AUTHORIZED UNBILLED (Thousands)	GALLONS SOLD (Thousands)	TOTAL NRW (Thousands)	% NON-ACCOUNT WATER (Thousands)
			=(C-D-E)/C	
26,769	181	15,471	11,117	41.53%
18,119	203	22,102	(4,186)	-23.10%
21,805	193	17,875	3,737	17.14%
22,833	102	17,794	4,937	21.62%
26,701	818	24,134	1,749	6.55%
28,229	646	25,099	2,484	8.80%
31,537	802	27,410	3,325	10.54%
30,095	1,874	24,610	3,611	12.00%
27,662	2,741	25,185	(264)	-0.95%
26,914	1,301	22,905	2,708	10.06%
23,540	1,676	22,763	(899)	-3.82%
23,348	315	19,918	3,115	13.34%
307,552	10,852	265,266	31,434	10.22%

EPCOR Water
Eastern Division - Mohave Water District
Operational Activity -

Description	JAN	FEB	MAR	APR	MAY
A Gallons Pumped					
Water Treatment	26,769	18,119	21,805	22,833	26,701
Wells					
B Gallons Purchased					
C Total Production	26,769	18,119	21,805	22,833	26,701

Authorized Unbilled/Consumption					
In-Plant Usage					
Mixing Chemicals - Field					
Well Pumped Waste					
Flushing Mains	181	203	193	102	818
Identified Fire Usage					
Vandalism					
Street Cleaning					
Draining Storage Tanks					
Online Analyzers & Chlorinators					
Field Meter Testing					
Fire Hydrant Maintenance					
Flushing Sewer Mains					
D Total Authorized Unbilled/Consumption	181	203	193	102	818

Gallons Sold					
Residential	14,092	16,262	14,604	15,856	20,766
Commercial	1,379	5,840	3,271	1,938	3,368
Industrial					
Fire Service					
OPA					
Resale					
Miscellaneous					
E Total Sales	15,471	22,102	17,875	17,794	24,134

Non-Account Water					
Gallons =C-D-E	11,117	(4,186)	3,737	4,937	1,749
Percentage =(C-D-E)/C	41.53%	(23.10%)	17.14%	21.62%	6.55%

Negative numbers indicate quantity or percentage above production or 100%

- North Mohave (08-068)
2014

Quantity of Water (Kgal)							
JUN	JUL	AUG	SEP	OCT	NOV	DEC	TOTAL
28,229	31,537	30,095	27,662	26,914	23,540	23,348	307,552
28,229	31,537	30,095	27,662	26,914	23,540	23,348	307,552

646	802	1,874	2,741	1,301	1,676	315	10,852
646	802	1,874	2,741	1,301	1,676	315	10,852

20,894	22,840	20,017	20,460	18,998	18,913	16,271	219,973
3,755	3,449	3,179	3,313	2,808	2,751	2,548	37,599
450	1,121	1,414	1,412	1,099	1,099	1,099	7,684
25,099	27,410	24,610	25,185	22,905	22,763	19,918	265,266

2,484	3,325	3,611	(264)	2,708	(899)	3,115	31,434
8.80%	10.54%	12.00%	(0.95%)	10.06%	(3.82%)	13.34%	10.22%

COMPANY NAME:	EPCOR Water
Name of System: Havasu	ADEQ Public Water System Number: 04-08-015

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		2	
FEBRUARY		1	
MARCH		4	
APRIL		4	
MAY		3	
JUNE		5	
JULY		4	
AUGUST		16	
SEPTEMBER		5	
OCTOBER		6	
NOVEMBER		8	
DECEMBER		9	
TOTALS →		67	

OTHER (description):

COMPANY NAME:	EPCOR Water
Name of System: Mohave	ADEQ Public Water System Number: 04-08-032

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		163	
FEBRUARY		25	
MARCH		58	
APRIL		89	
MAY		60	
JUNE		53	
JULY		148	
AUGUST		37	
SEPTEMBER		52	
OCTOBER		80	
NOVEMBER		40	
DECEMBER		50	
TOTALS →		855	

OTHER (description):

COMPANY NAME:	EPCOR Water
Name of System: Camp Mohave	ADEQ Public Water System Number: 04-08-037

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		0	
FEBRUARY		0	
MARCH		0	
APRIL		1	
MAY		0	
JUNE		0	
JULY		3	
AUGUST		0	
SEPTEMBER		0	
OCTOBER		2	
NOVEMBER		0	
DECEMBER		1	
TOTALS →		7	

OTHER (description):

COMPANY NAME:	EPCOR Water
Name of System:	Lake Mohave ADEQ Public Water System Number: 04-08-062

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		1	
FEBRUARY		0	
MARCH		0	
APRIL		3	
MAY		0	
JUNE		0	
JULY		1	
AUGUST		1	
SEPTEMBER		0	
OCTOBER		1	
NOVEMBER		0	
DECEMBER		0	
TOTALS →		7	

OTHER (description):

COMPANY NAME:	EPCOR Water		
Name of System:	Desert Foothills	ADEQ Public Water System Number: 04-08-137	

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		2	
FEBRUARY		4	
MARCH		1	
APRIL		4	
MAY			
JUNE		3	
JULY		3	
AUGUST		4	
SEPTEMBER		1	
OCTOBER		2	
NOVEMBER		2	
DECEMBER		3	
TOTALS →		29	

OTHER (description):

COMPANY NAME:	EPCOR Water
Name of System: Arizona Gateway	ADEQ Public Water System Number: 04-08-163

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY			
FEBRUARY			
MARCH			
APRIL			
MAY			
JUNE			
JULY			
AUGUST			
SEPTEMBER			
OCTOBER			
NOVEMBER			
DECEMBER			
TOTALS →		0	

OTHER (description):

COMPANY NAME:		EPCOR Water
Name of System:	Rio Vista	ADEQ Public Water System Number: 04-08-333

UTILITY SHUTOFFS / DISCONNECTS

MONTH	Termination without Notice R14-2-410.B	Termination with Notice R14-2-410.C	OTHER
JANUARY		0	
FEBRUARY		0	
MARCH		0	
APRIL		5	
MAY		0	
JUNE		2	
JULY		4	
AUGUST		0	
SEPTEMBER		1	
OCTOBER		1	
NOVEMBER		0	
DECEMBER		0	
TOTALS →		13	

OTHER (description):

COMPANY NAME:

Name of System: North Mohave

ADEQ Publi

UTILITY SHUTOFF

MONTH		Termination without Notice
		R14-2-410.B
JANUARY		
FEBRUARY		
MARCH		
APRIL		
MAY		
JUNE		
JULY		
AUGUST		
SEPTEMBER		
OCTOBER		
NOVEMBER		
DECEMBER		
TOTALS →		

OTHER (description):

EPCOR Water
ic Water System Number: 04-08-068

ES / DISCONNECTS

Termination with Notice R14-2-410.C	OTHER
1	
2	
3	
7	
5	
3	
4	
7	
2	
2	
36	

COMPANY NAME	EPCOR WATER
Name of System: Mohave Wishing Well	Wastewater Inventory Number (if applicable): 38-158

WASTEWATER COMPANY PLANT DESCRIPTION

TREATMENT FACILITY

TYPE OF TREATMENT (Extended Aerations, Step Aerations, Oxidation Ditch, Aerobic Lagoon, Anaerobic Lagoon, Trickling Filter, Septic Tank, Wetland, Etc.)	Extended aeration, trickling filter
DESIGN CAPACITY OF PLANT gallons Per Day	500,000 (Wishing Well Treatment Plant)

LIFT STATION FACILITIES

Location	Quantity of Pumps	Horsepower Per Pump	Capacity Per Pump (GPM)	Wet Well Capacity(gals)
Mountain View Drive	2	7.5	114	2,100
Lago Cove	2	3	17	1,000
Greens @ Los Lagos	2	15	326	4,650

FORCE MAINS

Size	Material	Length (in feet)
4"		5,418
6"		8,157

MANHOLES

CLEANOUTS

Type	Quantity	Quantity
Standard	538	27

COMPANY NAME	EPCOR WATER
Name of System: Mohave Arizona Gateway	Wastewater Inventory Number (if applicable):

WASTEWATER COMPANY PLANT DESCRIPTION

TREATMENT FACILITY

TYPE OF TREATMENT (Extended Aerations, Step Aerations, Oxidation Ditch, Aerobic Lagoon, Anaerobic Lagoon, Trickling Filter, Septic Tank, Wetland, Etc.)	Extended Aeration, San-Tec plant
DESIGN CAPACITY OF PLANT gallons Per Day	112,000 (Arizona Gateway Treatment Plant)

LIFT STATION FACILITIES

Location	Quantity of Pumps	Horsepower Per Pump	Capacity Per Pump (GPM)	Wet Well Capacity(gals)
Effluent Lift pump	1	1.4	70	

FORCE MAINS

Size	Material	Length (in feet)

MANHOLES

CLEANOUTS

Type	Quantity	Quantity
Standard	8	
Drop		

COMPANY NAME	EPCOR WATER
Name of System: Mohave Wishing Well	Wastewater Inventory Number (if applicable): 38-158

WASTEWATER COMPANY PLANT DESCRIPTION (CONTINUED)

COLLECTION MAINS

Size (in inches)	Material	Length (in feet)
4	n/a	
6	PVC	6,458
8	PVC	119,903
10	PVC	1,712
12	PVC	
15	n/a	8,075
18	n/a	
21	n/a	
24	n/a	
	TOTAL =	134,148

SERVICES

Size (in inches)	Material	Quantity
4	n/a	
6	n/a	
8	n/a	
12	n/a	
15	n/a	
	TOTAL =	0

For the following three items, list the utility owned assets in each category.

SOLIDS PROCESSING AND HANDLING FACILITIES	Sludge press
DISINFECTION EQUIPMENT (Chlorinator, Ultra-Violet, Etc.)	Chlorinator
FILTRATION EQUIPMENT (Rapid Sand, Slow Sand, Activated Carbon, Etc.)	Slow sand
STRUCTURES (Buildings, Fences Etc)	600' chain link fence, building with lab, chlorine building
OTHER Laboratory Equipment, Tools, Vehicles, Standby Power Generators, etc.	150 KW Cat gen-set, miscellaneous lab equipment, influent meter, effluent meter. Effluent pump.

COMPANY NAME	EPCOR WATER
Name of System: Mohave Arizona Gateway	Wastewater Inventory Number (if applicable):

WASTEWATER COMPANY PLANT DESCRIPTION (CONTINUED)

COLLECTION MAINS

Size (In inches)	Material	Length (In feet)
4	n/a	
6	PVC	
8	PVC	2,019
8	D.I.	
12	PVC	
16	n/a	150
18	n/a	
21	n/a	
24	n/a	
	TOTAL =	2,169

SERVICES

Size (In inches)	Material	Quantity
4	n/a	
6	PVC	
8	n/a	
12	n/a	
15	n/a	
	TOTAL =	0

For the following three items, list the utility owned assets in each category.

SOLIDS PROCESSING AND HANDLING FACILITIES	N/A
DISINFECTION EQUIPMENT (Chlorinator, Ultra-Violet, Etc.)	Chlorinator/de-chlorinator
FILTRATION EQUIPMENT (Rapid Sand, Slow Sand, Activated Carbon, Etc.)	None
STRUCTURES (Buildings, Fences Etc)	Blower building/chain link fencing
OTHER Laboratory Equipment, Tools, Vehicles, Standby Power Generators, etc.	Stand by generator

COMPANY NAME	EPCOR WATER
Name of System: Mohave Wishing Well	Wastewater Inventory Number (if applicable): 38-158

WASTEWATER FLOWS

MONTH/YEAR	NUMBER OF SERVICES	TOTAL MONTHLY SEWAGE FLOW (MG)	SEWAGE FLOW ON PEAK DAY (MG)
JANUARY	1,441	7.270	0.354
FEBRUARY	1,448	7.577	0.337
MARCH	1,493	7.659	0.292
APRIL	1,497	6.785	0.289
MAY	1,482	6.378	0.370
JUNE	1,486	5.694	0.229
JULY	1,492	5.986	0.222
AUGUST	1,486	5.501	0.236
SEPTEMBER	1,487	5.252	0.203
OCTOBER	1,497	5.684	0.207
NOVEMBER	1,516	6.146	0.234
DECEMBER	1,515	5.391	0.277
TOTALS ->		75.323	

PROVIDE THE FOLLOWING INFORMATION AS APPLICABLE

Method of Effluent Disposal (leach field, surface water discharge, reuse, injection wells, groundwater recharge, evaporation ponds, etc.)	Re-use
Wastewater Inventory Number (all wastewater systems are assigned an inventory number)	Place ID # 1784 LTF # 43063
Groundwater Permit Numbers	N/A
ADEQ Aquifer Protection Permit Number	P-102181
ADEQ Reuse Permit Number	N/A
EPA NPDES Permit Number	N/A

VERIFICATION
AND
SWORN STATEMENT
Taxes

VERIFICATION

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME)

Maricopa

NAME (OWNER OR OFFICIAL) TITLE

Gregory Barber, Controller

COMPANY NAME

EPCOR Water Arizona Inc.

DO SAY THAT THIS ANNUAL UTILITY PROPERTY TAX AND SALES TAX REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

I HEREBY ATTEST THAT ALL PROPERTY TAXES FOR SAID COMPANY ARE CORRECT AND PAID IN FULL.

I HEREBY ATTEST THAT ALL SALES TAXES FOR SAID COMPANY ARE CORRECT AND PAID IN FULL.

SIGNATURE OF OWNER OR OFFICIAL

823 - 445 - 2414
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS DAY OF

(SEAL)

COUNTY NAME	
MONTH	2014

SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES _____

EPCOR Water Arizona Inc.

YEAR ENDING 12/31/2014

INCOME TAXES

For this reporting period, provide the following:

Federal Taxable Income Reported	7,216,236.00
--	---------------------

Estimated or Actual Federal Tax Liability	(2,525,683.00)
---	----------------

State Taxable Income Reported	7,216,236.00
-------------------------------	--------------

Estimated or Actual State Tax Liability	(283,237.26)
---	--------------

Amount of Grossed-Up Contributions/Advances:

Amount of Contributions/Advances

Amount of Contributions Advances	
Amount of Gross-Up Tax Collected	-

Total Grossed-Up Contributions/Advances	
---	--

Decision No. 55774 states, in part, that the utility will refund any excess gross-up funds collected at the close of the tax year when tax returns are completed. Pursuant to this Decision, if gross-up tax refunds are due to any Payer or if any gross-up tax refunds have already been made, attach the following information by Payer: name and amount of contribution/advance, the amount of gross-up tax collected, the amount of refund due to each Payer, and the date the Utility expects to make or has made the refund to the Payer.

CERTIFICATION

The undersigned hereby certifies that the Utility has refunded to Payers all gross-up tax refunds reported in the prior year's annual report. This certification is to be signed by the President or Chief Executive Officer, if a corporation; the managing general partner, if a partnership; the managing member if a limited liability company or the sole proprietor, if a sole proprietorship.

SIGNATURE

DATE _____

PRINTED NAME

TITLE

**VERIFICATION
AND
SWORN STATEMENT (SEWER)
Intrastate Revenues Only**

VERIFICATION

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME)

Maricopa

NAME (OWNER OR OFFICIAL)

Gregory Barber

TITLE

Controller

COMPANY NAME

EPCOR Water Arizona Inc.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH

12

DAY

31

YEAR

2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401 ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2013 WAS:

Arizona IntraState Gross Operating Revenues Only (\$)

\$ 30,104,968

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 85,280
IN SALES TAXES BILLED, OR COLLECTED

**REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAX BILLED OR COLLECTED. IF FOR ANY OTHER REASON, THE REVENUE REPORTED ABOVE DOES NOT AGREE WITH TOTAL OPERATING REVENUES ELSEWHERE REPORTED, ATTACH THOSE STATEMENTS THAT RECONCILE DIFFERENCE. (EXPLAIN IN DETAIL)

SIGNATURE OF OWNER OR OFFICIAL

623 - 445 - 2414

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS

DAY OF

COUNTY NAME

MONTH

2014

(SEAL)

SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES

VERIFICATION

OF THE

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01 ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2013 WAS:

(THE AMOUNT IN BOX AT LEFT
INCLUDES \$ 74,754
IN SALES TAXES BILLED, OR COLLECTED

SIGNATURE OF OWNER OR OFFICIAL
623 - 445 - 2414
TELEPHONE NUMBER

NOTARY PUBLIC NAME	
COUNTY NAME	
MONTH	2014

SIGNATURE OF NOTARY PUBLIC

**VERIFICATION
AND
SWORN STATEMENT (WATER)
Intrastate Revenues Only**

VERIFICATION

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME)

Maricopa

NAME (OWNER OR OFFICIAL)

Gregory Barber

TITLE

Controller

COMPANY NAME

EPCOR Water Arizona Inc.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH

12

DAY

31

YEAR

2014

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401 ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2014 WAS:

Arizona IntraState Gross Operating Revenues Only (\$)

\$ 94,869,544

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 7,369,689
IN SALES TAXES BILLED, OR COLLECTED

****REVENUE REPORTED ON THIS PAGE MUST
INCLUDE SALES TAX BILLED OR COLLECTED.
IF FOR ANY OTHER REASON, THE REVENUE
REPORTED ABOVE DOES NOT AGREE WITH TOTAL
OPERATING REVENUES ELSEWHERE REPORTED,
ATTACH THOSE STATEMENTS THAT RECONCILE
DIFFERENCE. (EXPLAIN IN DETAIL)**

SIGNATURE OF OWNER OR OFFICIAL

623 - 445 - 2414

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS

DAY OF

COUNTY NAME

MONTH

2014

(SEAL)

MY COMMISSION EXPIRES

SIGNATURE OF NOTARY PUBLIC

VERIFICATION

1. THE UNDERSIGNED

COUNTY OF (COUNTY NAME)

MagScore

NAME (OWNER OR OFFICIAL)

TITLE

Gregory Barber

Controller

COMPANY NAME

EPCOR Water Arizona Inc.

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2014

SWORN STATEMENT

Arizona IntraState Gross Operating Revenues Only (\$)

\$ 71,035,716

(THE AMOUNT IN BOX AT LEFT

INCLUDES \$ 5,610,432

IN SALES TAXES BILLED, OR COLLECTED

SIGNATURE OF OWNER OR OFFICIAL

623 - 445 - 2414

TELEPHONE NUMBER

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS

DAY OF

NOTARY PUBLIC NAME

COUNTY NAME

MONTH	2014
-------	------

(SEAL)

SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES

EXHIBIT F

STATE OF ARIZONA



Office of the CORPORATION COMMISSION

CERTIFICATE OF GOOD STANDING

To all to whom these presents shall come, greeting:

I, Jodi A. Jerich, Executive Director of the Arizona Corporation Commission, do hereby certify that

*****EPCOR WATER ARIZONA INC.*****

a domestic corporation organized under the laws of the State of Arizona, did incorporate on December 30, 1949.

I further certify that according to the records of the Arizona Corporation Commission, as of the date set forth hereunder, the said corporation is not administratively dissolved for failure to comply with the provisions of the Arizona Business Corporation Act; and that its most recent Annual Report, subject to the provisions of A.R.S. sections 10-122, 10-123, 10-125 & 10-1622, has been delivered to the Arizona Corporation Commission for filing; and that the said corporation has not filed Articles of Dissolution as of the date of this certificate.

This certificate relates only to the legal existence of the above named entity as of the date issued. This certificate is not to be construed as an endorsement, recommendation, or notice of approval of the entity's condition or business activities and practices.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the official seal of the Arizona Corporation Commission. Done at Phoenix, the Capital, this 20th Day of April, 2015, A. D.



Jodi A. Jerich
Jodi A. Jerich, Executive Director

By: _____ 1219602

RECEIVED

2015 JUN - 1 A 10:36

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH
Chairman

AZ CORP COMMISSION
DOCKET CONTROL

BOB STUMP
Commissioner

BOB BURNS
Commissioner

TOM FORESE
Commissioner

DOUG LITTLE
Commissioner

IN THE MATTER OF THE JOINT
APPLICATION OF WILLOW VALLEY
WATER CO., INC. AND EPCOR WATER
ARIZONA, INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

W-01732A-15-0131
W-01303A-15-0131

SUPPLEMENT TO APPLICATION
SEEKING APPROVAL OF
RECOVERY OF PRICE PAID IN
EXCESS OF RATE BASE

On April 22, 2015, Willow Valley Water Company, Inc. ("Willow Valley") and EPCOR Water Arizona Inc. ("EWAZ") filed an application requesting that the Arizona Corporation Commission ("Commission") approve the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ (the "Application"). The Application also requested that the Commission approve a mechanism to allow EWAZ's recovery of the going concern value component of the purchase price paid to Willow Valley. After discussions with Utilities Division Staff, EWAZ, in this supplemental filing, describes the surcharge mechanism it respectfully requests the Commission approve as part of this proceeding.

1. Background

As stated in the Application, EWAZ seeks recovery of approximately \$226,000 through a surcharge mechanism to be approved as part of the sale of Willow Valley's

EXHIBIT

EWAZ-3
ADMITTED

1 utility system and transfer of its CC&N to EWAZ. EWAZ believes the recovery of that
2 portion of the purchase price in excess of Willow Valley's rate base (the "Acquisition
3 Premium") is appropriate in this instance for the following reasons:

4 (A) Going Concern Value of Willow Valley. The purchase price for the Willow
5 Valley system reflects the fair market value of the assets and operations being
6 purchased, including the value of Willow Valley's CC&N, but exceeds the rate
7 base value of the property, plant and equipment ("PPE") as set out in the Water
8 Utility Plant schedules attached to the Willow Valley Water Co., Inc. Annual
9 Report for year ending 12/31/2014. In other words, the payment of a premium for
10 Willow Valley's PPE over and above the net book value reflects the going
11 concern value of Willow Valley's operations (i.e., the net book value of the PPE
12 and the expectation that Willow Valley will be able to earn a continued fair return
13 on its investment as part of the EWAZ water utility system).

14 (B) Significant investments will be required upon purchase by EWAZ. EWAZ will
15 need to make significant capital investments to increase the reliability and quality
16 of the Willow Valley system, such as replacement of non-operational system
17 valves, installation of a more robust backwash effluent discharge retention system,
18 and necessary maintenance of storage tanks. EWAZ is willing, in accordance
19 with the proposal set out below, to implement a 5-year capital improvement
20 program, which would expend approximately \$200,000 per year of capital in
21 excess of the System Improvement Benefit ("SIB") investments authorized in
22 Decision No. 74364 (February 26, 2014), for a total capital investment of between
23 \$300,000 and \$500,000 annually for the five years following its acquisition of
24 Willow Valley. The surcharge mechanism described below will allow EWAZ to
25 earn continuing fair returns following the acquisition in light of these significant
26 new capital investments.

1 (C) More Reliable Water Service. As a result of the increased capital investment,
2 existing Willow Valley customers will receive higher quality and more reliable
3 water service. In addition, customers served by EWAZ will receive a level of
4 service and support that meets or exceeds the service currently provided by
5 Willow Valley.

6 (D) Significant Decrease to Cost of Debt. EPCOR Water USA Inc. (EPCOR USA)
7 has the ability to maintain a stronger credit rating than Willow Valley on a stand-
8 alone basis. This stronger credit rating will enable EPCOR USA and its operating
9 subsidiaries, such as EWAZ, to borrow needed funds at a lower cost than would
10 otherwise be possible for Willow Valley, including any debt used to finance the
11 future capital investments. Willow Valley's current capital structure includes an
12 embedded cost of debt of 6.1 percent, whereas EWAZ's current cost of debt is
13 4.29%. The long-term bond ratings of EPCOR USA and its subsidiary, EWAZ,
14 are currently A- (S&P) and Baa2 (Moody's).

15 2. Proposal

16 The Company has sought to develop a mechanism that supports the Commission's
17 desire to accelerate the consolidation of small, troubled water systems or systems with
18 demonstrated needs for capital improvements to better provide safe and reliable water
19 service with minimal impacts to customers. The mechanism recommended for approval
20 by the Commission does not specifically include the Acquisition Premium in rate base, but
21 rather provides an incentive for companies, including in this instance, EWAZ, to acquire a
22 small water company with demonstrated needs for capital improvements and to invest in
23 needed infrastructure at heightened levels through the adjustment mechanism set out below
24 (the "Acquisition Adjustment").

25 The amount sought to be recovered through the Acquisition Adjustment is the
26 difference between the going concern/fair market value of Willow Valley, as reflected in

the purchase price, and the original cost of the plant, property, and equipment being acquired less accumulated depreciation (the Net Utility Plant in Service), further reduced by the recorded values of property contributed or advanced by others.

The following calculation sets out the amount sought to be recovered under the above definition:

Net Utility Plant in Service	\$2,796,377
Less: Advances and Contributions	(\$ 528,346)
	\$2,268,031
Purchase Price	\$2,494,834
Less:	(\$2,268,031)
Acquisition Premium	\$ 226,803

The table below illustrates several scenarios under which the Commission could authorize recovery of the Acquisition Premium. This Acquisition Adjustment would be recovered through a monthly surcharge over 10, 12, or 15 years, with recovery of the surcharge phased-in (and the surcharge adjusted on an annual basis) as the additional capital expenditures are made and projects completed. Because the expenditures would be made over a period of five years, and because the recovery time frame would be limited, the surcharge will not permit over recovery.

5-Year Capital Spend	% Commission Authorized Incentive	\$ Authorized Incentive	Annual Operating Income Produced	Annual Revenue Required
\$ 1,000,000	10.00%	\$100,000	\$ 6,740	\$11,054
\$ 1,000,000	15.00%	\$150,000	\$10,110	\$16,580
\$ 1,000,000	20.00%	\$200,000	\$13,480	\$22,107

In the above scenario, EWAZ would commit to spend \$1,000,000 over five years in the Willow Valley system for projects not outlined in the existing SIB. EWAZ is currently evaluating the Willow Valley system to develop a long-term capital plan but has identified

several projects which will be further reviewed, including 1) a system interconnect between the King Street and Lake Cimarron areas of the existing Willow Valley system to provide operational flexibility and redundancy, 2) replacement of system valves that are currently non-operational, 3) a more robust backwash effluent discharge retention system to prevent leaching into the aquifer, 4) necessary maintenance of three storage tanks, and 5) replacement or repair of failed flow and backwash meters and other infrastructure projects.

A Commission approved 20% incentive would provide for an increase to annual operating income as shown above. The required revenues, providing for increases to income and property taxes, are also shown.

% Commission Authorized Incentive	10-Year Operating Income	% of Premium Recovered	12 - Year Operating Income	% of Premium Recovered	15-Year Operating Income	% of Premium Recovered	Cost to customer monthly	% of Typical Bill @5k Gal
10.00%	\$67,400	29.72%	\$80,880	35.66%	\$101,100	44.58%	\$0.61	1.11%
15.00%	\$101,100	44.58%	\$121,320	53.49%	\$151,650	66.86%	\$0.91	1.66%
20.00%	\$134,800	59.43%	\$161,760	71.32%	\$202,200	89.15%	\$1.21	2.22%

The table above demonstrates how the Acquisition Adjustment will lead to partial recovery of the Acquisition Premium. The circled area shows that an authorized incentive of 20% above planned SIB capital expenditures would provide for 89.15% recovery of the Acquisition Premium via an eventual surcharge of \$1.21 per month over a 15-year period. The impact to customers would be approximately a 2.22% increase, or about a \$1.21 per month increase to the average bill.

3. Summary

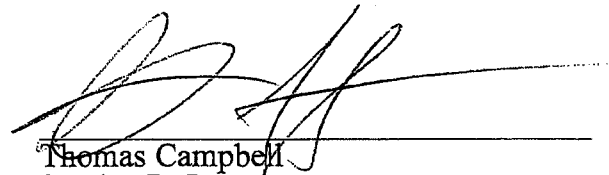
If approved by the Commission, EWAZ would work with Commission Staff to create standard reporting procedures to monitor annual progress of the additional capital projects, and to phase in the surcharge as projects are completed. In addition, EWAZ would provide a report to Commission Staff annually, summarizing total surcharge

1 revenues collected and provide for early termination of the surcharge should full recovery
2 of the Acquisition Premium occur prior to the authorized term of recovery. EWAZ would
3 not expect the surcharge to continue further than the originally-authorized term, and would
4 accept the risk of non-recovery of the full Acquisition Premium upon expiration of the
5 authorized surcharge period.

6 EWAZ respectfully requests that the Commission authorize the proposed
7 Acquisition Adjustment to allow for recovery of the going concern value paid for Willow
8 Valley and approve the concept to allow for timely recovery of such amounts in future
9 acquisitions in order to further the Commission's stated desire to accelerate the
10 consolidation of small and/or troubled water systems.

11 RESPECTFULLY SUBMITTED this 29th day of May, 2015.

12 LEWIS ROCA ROTHGERBER, LLP

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15
16
17
18
19

Thomas Campbell
Stanley B. Lutz
201 E. Washington Street
Phoenix, AZ 85004
(602) 262-5704
Attorneys for EPCOR Water Arizona, Inc.

20 ORIGINAL AND thirteen (13) copies
21 of the foregoing hand-delivered this
22 29th day of May, 2015, to:

23 The Arizona Corporation Commission
24 Utilities Division – Docket Control
25 1200 W. Washington Street
26 Phoenix, Arizona 85007

Copy of the foregoing hand-delivered
this 29th day of May, 2015, to:

1 Steve Olea
Utilities Division
2 Arizona Corporation Commission
1200 W. Washington Street
3 Phoenix, Arizona 85007

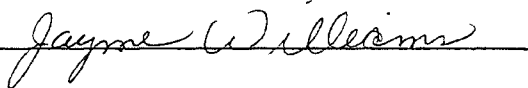
4 Dwight Nodes
Administrative Law Judge, Hearing Division
5 1200 W. Washington Street
Phoenix, Arizona 85007

6 Janice Alward, Chief Counsel,
7 Legal Department
Arizona Corporation Commission
8 1200 W. Washington Street
Phoenix, Arizona 85007

9
10 Copy of the foregoing mailed
this 29th day of May, 2015, to:

11 Timothy Sabo
12 Snell & Wilmer
13 400 E. Van Buren, Suite 800
One Arizona Center
14 Phoenix, Arizona 85004

15 Daniel Pozefsky
16 Residential Utility Consumer Office
1110 W. Washington Street, Suite 220
17 Phoenix, AZ 85007

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH, Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION OF
WILLOW VALLEY WATER CO., INC. AND EPCOR
WATER ARIZONA, INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF
CERTIFICATE OF CONVENIENCE AND
NECESSITY

DOCKET NOS: W-01732A-15-0131
W-01303A-15-0131

REBUTTAL TESTIMONY
OF
SARAH MAHLER
ON BEHALF OF
EPCOR WATER ARIZONA, INC.
OCTOBER 23, 2015



**REBUTTAL TESTIMONY
OF
SARAH MAHLER
ON BEHALF OF
EPCOR WATER ARIZONA, INC.
OCTOBER 23, 2015**

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EXECUTIVE SUMMARY

Ms. Mahler's Rebuttal Testimony focuses primarily on the mechanism EWAZ has proposed to allow it an opportunity to receive a return of the price paid in excess of rate base. Her testimony also responds to recommendations made in the Direct Testimony filed on behalf of Utilities Division Staff and the Residential Utility Consumer Office regarding Accumulated Deferred Income Taxes ("ADIT"), Staff's calculations related to the purchase price, customer security deposits and EWAZ's capital structure.

1 **I. INTRODUCTION AND QUALIFICATIONS**

2 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND TELEPHONE**
3 **NUMBER.**

4 A. My name is Sarah Mahler. My business address is 2355 W. Pinnacle Peak Road, Suite
5 300, Phoenix, Arizona 85027, and my business phone is (623) 445-2420.

6 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

7 A. I am employed by EPCOR Water (USA) Inc. ("EWUS"), the owner of EPCOR Water
8 Arizona, Inc. ("EWAZ" or "Company"), as Manager, Rates.

9 **Q. PLEASE DESCRIBE YOUR RESPONSIBILITIES WITH EWAZ.**

10 A. My primary responsibilities with EWUS are to manage the preparation of rate
11 applications and other regulatory filings consistent with the applicable regulatory
12 agency's filing requirements in Arizona and New Mexico. I also assist the Director of
13 Regulatory & Rates with research and public outreach.

14 **Q. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AND**
15 **EDUCATION.**

16 A. I have been employed by EWUS since January 2015. I have more than 5 years of
17 experience in public utility accounting and regulation and another 10 years of experience
18 managing accounting practices and policies, including expertise in homebuilding,
19 construction, software and audit/public accounting.

20 I have a Master of Business Administration from the University of Phoenix. I hold
21 Bachelor of Science degrees from Arizona State University in Accounting and Global
22 Business with an emphasis on Finance.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. EWAZ is seeking to purchase the assets of the Willow Valley water system. My testimony will focus primarily on the mechanism EWAZ has proposed to allow it an opportunity to receive a return of its price paid in excess of rate base. My testimony will also address the Company's response to recommendations by Staff and RUCO regarding Accumulated Deferred Income Taxes ("ADIT"), Staff's calculations related to the purchase price, customer security deposits and EWAZ's capital structure.

III. RESPONSE TO STAFF'S AND RUCO'S POLICY ARGUMENTS AGAINST THE PROPOSED ACQUISITION ADJUSTMENT MECHANISM

Q. STAFF AND RUCO OBJECT TO THE COMPANY'S PROPOSED ACQUISITION ADJUSTMENT MECHANISM, WHY SHOULD IT BE ADOPTED?

A. Staff's objection to the Acquisition Adjustment mechanism is that the projects themselves warrant no special treatment. Staff argues the projects proposed by the Company are typically considered part of the utility's routine operating and maintenance expenses and should be addressed as part of the normal course of utility operations. The Company has never represented that these investments require special treatment. The Company believes that the investment needed in Willow Valley to immediately address existing system wide losses and other critical improvements should be eligible for an upward adjustment to recover this level of investment in a system that needs infrastructure.

However, the issue to be addressed is whether the Commission should design and adopt a mechanism to incentivize financially viable and responsible water utilities to invest in

1 challenged systems. The current regulatory environment discourages Class A water
2 utilities from 1) purchasing systems with significant immediate capital investment
3 requirements, and 2) paying the fair value determined in an arms-length transaction when
4 that fair value exceeds the book value of the assets. The Commission should create a
5 mechanism which allows for an equitable transfer of ownership that benefits both the
6 community and the utility.

7 RUCO's opposition is based on the erroneous premise that EWAZ is seeking approval of
8 an acquisition premium to be included in rate base.¹ RUCO references a memorandum
9 from the Utilities Division dated June 29, 2001, which was not adopted by the
10 Commission, which details a proposed policy for Class D and E water system
11 acquisitions. RUCO lists six conditions from that memorandum which Staff identified
12 must be met in order for an acquisition premium to be approved and included in rate base
13 of the acquiring company. RUCO also quotes several excerpts from the 1943 Niagara
14 Falls Power Co. decision in which the inclusion of acquisition premiums in rate base is
15 detrimental to the customer in two ways:

- 16 1) The seller might persuade the buyer to pay more than the recorded rate
17 base simply because the difference would be used to increase rates paid by
18 the public.
- 19 2) Buyers might become indifferent to the purchase price and sellers might
20 exert more force on the asking price, unwinding the economics of a fairly
21 assessed, arms-length purchase price.

22 EWAZ has specifically designed the Acquisition Adjustment Mechanism to address
23 RUCO's concerns by requiring the purchasing company to pay only fair value for an
24 acquired system. RUCO quotes Professor Bonbright in "Principles of Public Utility
25 Rates" as stating that the utility shall be "compensated for devoting capital to the public

¹ The Company's Supplemental filing in this docket defines and uses the term "Acquisition Premium". However, as explained below, the Company's proposed "Acquisition Adjustment Mechanism" is fundamentally different than the acquisition premiums discussed by Staff and RUCO.

1 service.” EWAZ seeks a mechanism to incentivize the purchasing company to do just as
2 Professor Bonbright states. The proposed Acquisition Adjustment Mechanism
3 compensates the acquiring company only for investing much needed capital in a system,
4 where that investment would not otherwise have been made.

5 **Q. WHY IS THE MECHANISM APPROPRIATE IN THIS CASE?**

6 A. There are several reasons discussed below that justify approving a mechanism such as the
7 one proposed by the Company.

8 (I) Going Concern Value of Willow Valley. The purchase price for the Willow Valley
9 system reflects the fair market value of the assets and operations being purchased.
10 The price includes the value of Willow Valley’s CC&N, but exceeds the value of the
11 property, plant, and equipment (“PPE”) as reflected in the Water Utility Plant
12 schedules attached to the Willow Valley Water Co., Inc. Annual Report for the year
13 ending December 31, 2014. In other words, the payment of a premium for Willow
14 Valley’s PPE over and above the net book value reflects the going concern value of
15 Willow Valley’s operations (i.e., the net book value of the PPE and the expectation
16 that Willow Valley will continue to be able to earn a fair return on its investment as
17 part of the EWAZ water and wastewater utility system) as well as a recognition that
18 Willow Valley’s assets still in service, but with a net book value of zero, still have
19 value.

20 (II) Significant investments will be required upon purchase by EWAZ in order to reduce
21 water loss. EWAZ will need to make significant capital investments to increase the
22 reliability and quality of the Willow Valley system such as replacement of defective
23 system valves, installation of a more robust backwash effluent discharge retention
24 system, and necessary maintenance of storage tanks. EWAZ is willing to implement

1 a five-year capital improvement program, as discussed in Mr. Bradford's testimony,
2 which would expend approximately \$200,000 annually for the five years following its
3 acquisition of Willow Valley. The Acquisition Adjustment Mechanism proposed by
4 the Company will allow EWAZ to earn continuing fair returns following the
5 acquisition in light of these significant new capital investments.

6 (III) Stay of SIB. Investments that were planned but not completed pursuant to the now-
7 stayed SIB program should be eligible for the Acquisition Adjustment Mechanism as
8 well as other necessary projects completed in the five years following the close of the
9 transaction.

10 (IV) More Reliable Water and Customer Service. As a result of the increased capital
11 investment, existing Willow Valley customers will receive higher quality and more
12 reliable water service. In addition, Willow Valley customers served by EWAZ will
13 receive the same level of service and support as do customers in other EWAZ
14 districts; service and support that meets or exceeds the service currently provided by
15 Willow Valley.

16 (V) Fair Value. RUCO's longstanding opposition to any regulatory mechanism has rested
17 on the absence of a fair value determination. The four variables in the Company's
18 proposed Acquisition Adjustment Mechanism will be approved in the Commission's
19 Decision to approve the transfer of assets. However, implementation of the
20 mechanism will not occur until Willow Valley's next formal rate case. At that time,
21 Staff and RUCO will have an opportunity to assess the usefulness and value of the
22 investments made subsequent to the system's transfer of ownership and the
23 Acquisition Adjustment Mechanism will be implemented at that time. Subsequent
24 rate filings, up to a test year ended December 31, 2021, will include provisions for

recalculation of the Acquisition Adjustment Mechanism. Investments made after December 31, 2021 will not be eligible for the Acquisition Adjustment Mechanism.

Q. RUCO'S OPPOSITION TO EWAZ'S REQUEST TO RECOVER THE AMOUNTS IT IS PAYING TO ACQUIRE WILLOW VALLEY IN EXCESS OF RATE BASE IS PREMISED ON THE COMPANY INCLUDING AN ACQUISITION PREMIUM IN RATE BASE. IS EWAZ REQUESTING AN ACQUISITION PREMIUM TO BE INCLUDED IN RATE BASE IN THIS PROCEEDING?

A. No. The Company is not requesting that an acquisition premium be included in rate base. Staff and RUCO have misunderstood the Company's request. The Company is going to pay a premium, but it is not requesting the premium be included in rate base in this case or any future rate case. Staff and RUCO have confused the proposed Acquisition Adjustment Mechanism and implied the Company is requesting that a premium be included in rate base AND that the Company would also receive a premium on improvements made subsequent to the sale. This is not the case.

Q. STAFF WITNESS GERALD BECKER STATES THE COMPANY IS PROPOSING AN ACQUISITION PREMIUM AND AN ACQUISITION ADJUSTMENT. WHY IS MR. BECKER MISTAKEN AND EXPLAIN THE DIFFERENCE?

A. Mr. Becker states that the transfer of Willow Valley from Global to EWAZ does not warrant payment or regulatory recognition of an acquisition premium. EWAZ strongly believes that given the condition of the infrastructure and the capital needed to make the necessary improvements the transfer does warrant payment of an amount in excess of rate base. EWAZ is not, however, asking for recovery of a return on and of the acquisition premium for regulatory purposes, but rather only a return of that premium.

1 As with RUCO, Staff's opposition is premised on the mistaken idea that an acquisition
2 premium would be included in rate base, and the Company would receive a return on the
3 premium and a return of the premium through an associated amortization.

4 In contrast, the Company's proposal provides a means whereby the Company (or any
5 acquiring company), through proper stewardship and investment in an acquired system, is
6 provided the opportunity over a period of years to receive repayment of the original price
7 paid in excess of rate base.

8 Under the Company's proposal, the Company would simply receive a repayment of the
9 amount paid in excess of rate base without any consideration for the time value of money
10 over a period of years or any return on those funds. Those funds, the acquisition
11 premium, would not be included in rate base.

12 **Q. WHAT IS THE COMPANY REQUESTING?**

13 **A.** EWAZ is asking that the Company be given the opportunity to have the amounts it is
14 paying to acquire Willow Valley in excess of Willow Valley's rate base returned to it
15 after the Company has invested a significant amount of capital (currently estimated to be
16 one million dollars) to address water loss (in excess of 26%) and operational challenges
17 in the Willow Valley system. The Company is requesting the price paid in excess of rate
18 base, which will be 10% of rate base or approximately \$200,000, be recovered by EWAZ
19 over 15 years by adding a small charge currently estimated to be \$1.21 per month to each
20 Willow Valley customer's bill commencing only after a fair value determination of the
21 rate base after the investments have been placed in service.

22 **Q. PLEASE EXPLAIN HOW THE RECOVERY OF THE COMPANY'S**
23 **INVESTMENT WOULD BE IMPLEMENTED.**

1 A. As investments are completed and placed in service, the Company would file a rate case
2 application that would include these new capital investments and compute an additional
3 20% premium that would represent the incentive on which to compute a separate revenue
4 requirement to be recovered over a period of no greater than 15 years.

5 **Q. IS THE COMPANY SEEKING A SEPARATE SURCHARGE TO RECOVER**
6 **THE 20% PREMIUM?**

7 A. Yes. The revenue requirement effect of the 20% premium will be calculated and
8 collected via a separate surcharge for a period of 15 years or until the acquisition
9 premium has been recovered, whichever occurs first.

10 **Q. HAVE YOU PREPARED AN ILLUSTRATION OF THE COMPANY'S**
11 **PROPOSAL TO COMPUTE THE 20% PREMIUM?**

12 A. Yes. An illustrative example is attached as Exhibit SM-1.

13 **Q. WOULD THE RATE CASE APPLICATION INCLUDE ALL STANDARD**
14 **FILING REQUIREMENT SCHEDULES?**

15 A. Yes. All standard filing schedules, Schedules A through Schedule H, would be prepared
16 and submitted for review by the ACC Staff and other interested parties to the case. The
17 Company would also prepare a cost of capital to determine the appropriate rate of return
18 to be applied to the Rate Base.

19 **Q. HOW IS THIS CHARGE CALCULATED?**

20 A. There are four variables to the calculation that are discussed below. Illustrative
21 calculations in support of the Company's proposal are attached as Exhibit SM-1.

22 The first variable is the additional capital that EWAZ identified as potential projects to
23 invest in the five-year period subsequent to the close of the transaction. At this time, the
24 potential projects have been estimated at approximately \$1.0 million

1 The second variable is the premium on the estimated \$1.0 million the Company plans to
2 invest in the first 5 years after the close of the transaction. EWAZ is seeking additional
3 revenue based on the revenue requirement of a 20 percent premium on the first five years
4 of capital investment also referred to as an Acquisition Incentive. The Acquisition
5 Incentive as proposed would be charged to customers for a finite period of time.

6 The third variable is the rate of return. The Company's illustrative calculation in Exhibit
7 SM-1 uses a 10 percent return on equity ("ROE") to determine the overall cost of capital
8 (the ROE would be updated in the rate case application discussed above). As illustrated
9 in Exhibit SM-1, that results in a rate of return (ROR) of 6.74 percent. The actual ROR
10 to be used for this calculation would be determined in the rate case filing to implement
11 recovery of the new investment.

12 The first three variables produce a revenue requirement of \$22,107 that the Company
13 would recover from its customers.

14 The fourth and final variable is the length of time the Company would be allowed to
15 place a small charge on customer's monthly bills, to recover the Acquisition Incentive
16 revenue requirement of \$22,107. The Company has proposed a 15 year period, in which
17 the Company would collect approximately \$331,608 in revenues or \$200,722 in
18 operating income in its illustrative calculations. As explained below, this amount would
19 not be included in the calculation of rate base in future rate proceedings.

20 **Q. WHAT IS THE ACCOUNTING TREATMENT PROPOSED BY THE COMPANY**
21 **FOR THIS MECHANISM?**

1 A. Upon approval of the transfer of assets to EWAZ, the price paid in excess of rate base
2 will be recorded to a Regulatory Asset balancing account. This account will NOT be
3 added to the calculation of rate base for any future rate proceedings as Staff supposes.
4 EWAZ does not intend to earn a return on the premium paid. The surcharge (as
5 calculated above) would be collected from customers monthly via their normal cycle
6 billing. The regulatory asset would be credited monthly and reduce slowly over time (15
7 years in the Company's proposal). The Company would report this balance to the
8 Commission on an annual basis. The charge to customers would end upon the earlier of
9 1) depletion of the regulatory asset or 2) 15 years. See Exhibit SM-2.

10 **IV. RESPONSE TO STAFF AND RUCO REGARDING CREATION OF A**
11 **REGULATORY LIABILITY FOR ACCUMULATED DEFERRED INCOME**
12 **TAXES ("ADIT")**

13 **Q. STAFF AND RUCO BOTH RECOMMEND THE CREATION OF A**
14 **REGULATORY LIABILITY IN RELATION TO GLOBAL'S ADIT BALANCE.**
15 **HOW DOES THE COMPANY RESPOND?**

16 A. EWAZ is opposed to the creation of a Regulatory Liability on Willow Valley's
17 regulatory ledgers valued at the updated balance upon close. Staff's is imputing the value
18 of ADIT and reclassifying the ADIT balance as a regulatory liability. If approved this
19 action sets in place a policy which will have a negative impact on the consolidation of
20 small water systems in the State of Arizona, because it may make it more difficult to
21 reach a satisfactory purchase price. In fact it is not at all certain that the parties to the
22 asset transfer contemplated by this Application will be able to close the transaction if the
23 ADIT-associated Regulatory Liability as proposed by Staff and RUCO is included in the
24 final order. Also, if this policy is adopted by the Commission, consistent treatment of
25 both ADIT asset balances and liability balances must be utilized.

1 If Staff's recommendation is adopted, however, EWAZ recommends that amortization of
2 this liability commence immediately upon transfer, at a rate of 14.3% per year for 7
3 years. This amounts to approximately \$3,175 on December 31, 2014's balance which
4 will be updated upon close. The 7 year amortization is based upon the Company's
5 analysis of Global's ADIT balance. The response to Staff's data request number GWB
6 1.6 demonstrates that Global's net ADIT balance declined from \$367,598 to \$260,224
7 between December 31, 2011 and December 31, 2014, or \$35,791 per year. Therefore, a 7
8 year amortization at \$37,175 per year is appropriate.

9 **V. RESPONSE TO STAFF'S CALCULATION OF PURCHASE PRICE AND**
10 **PREMIUM PAID**

11 **Q. DOES THE COMPANY HAVE ANY ISSUES, BEYOND STAFF'S PROPOSED**
12 **TREATMENT OF ADIT, WITH STAFF WITNESS GERALD BECKER'S RATE**
13 **BASE CALCULATIONS?**

14 **A.** Mr. Becker incorrectly subtracts customer security deposits from rate base. Mr.
15 Becker's calculation on page 8 of his testimony reduces the \$1,964,397 he
16 calculated by \$31,898 (the amount of customer security deposits held by Willow
17 Valley) resulting in his erroneously calculated rate base of \$1,932,499. If Mr.
18 Becker's intent was to reflect the fact that the Company will not be acquiring the
19 customer security deposits, as provided under the terms of the purchase
20 agreement, Mr. Becker should have added the \$31,898 instead of subtracting that
21 amount.

22 **Q. STAFF STATES THERE IS AN UNEXPLAINED DIFFERENCE OF \$11,513 IN**
23 **THE NET PLANT AMOUNTS PROVIDED BY EWAZ. HOW DO YOU**
24 **RESPOND?**

1 A. The response to data request number RUCO 2.08, attached as Exhibit SM-3 and
2 delivered to Staff on June 26, 2015, explains the differences in the net plant for Willow
3 Valley. The \$11,513 is made up of three components: 1) EWAZ has agreed to purchase
4 Willow Valley's Construction Work in Progress (CWIP) of \$19,767, which is not
5 typically included in the calculation of Rate Base, 2) EWAZ has excluded assets with a
6 net book value of \$8,255 from its purchase, and 3) the net plant includes a correction of
7 (\$780) to the Accumulated Depreciation balance. The amount of these three previously
8 explained differences is \$11,512.

9 **Q. WILL GLOBAL FILE A REVISION TO THE ANNUAL REPORT TO THE**
10 **COMMISSION REFLECTING THE DIFFERENCE IN THE ACCUMULATED**
11 **DEPRECIATION BALANCE?**

12 A. Yes. EWAZ has asked that Global revise its Annual Report to the Commission to reflect
13 the correct Accumulated Depreciation balance and they have advised the Company that
14 they will make that revision.

15 **VI. RESPONSE TO STAFF'S RECOMMENDATION REGARDING**
16 **CUSTOMER SECURITY DEPOSITS**

17 **Q. STAFF RECOMMENDS THAT EWAZ ASSUME THE CUSTOMER SECURITY**
18 **DEPOSITS HELD BY WILLOW VALLEY. DOES THE COMPANY AGREE?**

19 A. No, EWAZ does not agree. Mr. Becker's primary concern is the potential for increased
20 bad debt, which could burden other customers in future rates cases. In EWAZ's Mohave
21 system, a few miles from the Willow Valley system, bad debt is less than 1% of
22 revenues. EWAZ does not currently require its customers to pay a security deposit. In
23 the Willow Valley system, customers are required to pay a security deposit of \$110.
24 EWAZ's exemplary customer service, advanced website, disconnection policy, and

1 customer education and notification campaigns have made it unnecessary for EWAZ to
2 implement and manage a costly, time intensive customer security deposit program.
3 Deposit programs require programming to the billing platform, administration monthly to
4 assure compliance with ACC rules on water including: deposit interest management,
5 refunds to customers with 12 on-time payments, recollection after two late payments and
6 processing refund checks to customers with a credit balance after final billing. These
7 overhead cost savings will benefit Willow Valley customers under EWAZ ownership.
8 Willow Valley customers will also be refunded their current security deposit by Global
9 Water along with applicable interest within 30 days of the transfer of assets to EWAZ.
10 Willow Valley's balance sheet as of December 31, 2014 listed customer accounts
11 receivable of \$11,694, customer prepayments of \$28,883, and customer deposits
12 of \$31,898. This suggests that most Willow Valley customers prefer to prepay
13 their bill, and should not also be required to submit a security deposit.

14 **VII. RESPONSE TO STAFF'S CONCERNS ABOUT UNBALANCED CAPITAL**
15 **STRUCTURE**

16 **Q. STAFF HAS RECOMMENDED PLACING EWAZ ON NOTICE THAT IT MUST**
17 **ATTEMPT TO BALANCE ITS CAPITAL STRUCTURE. HOW DO YOU**
18 **RESPOND?**

19 A. Staff suggests that EWAZ might attempt to support a 100% equity capital structure upon
20 presentation of its next rate case involving Willow Valley. Staff's concern appears to be
21 predicated on treating the Willow Valley system as a stand-alone system and not as a
22 division of EWAZ. The Willow Valley system will be owned by EWAZ and the
23 prevailing capital structure of EWAZ at the time of any future rate case will be applied to
24 Willow Valley.

1 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

2 **A. Yes.**

EXHIBIT SM-1

EPCOR Water Arizona Inc.

Simplified Mechanism Demonstration

Docket No. W-01732A-15-0131

Docket No. W-01303A-15-0131

Exhibit SM-1

line	Variable Component of Mechanism	Calculation of Income Requirement *	Acquisition Incentive (24%) **	Total Income Requirement
1	Capital Invested	\$ 1,000,000	\$ 200,000	\$ 1,200,000
2	ROR (10% ROE) EPCOR Water Arizona		5.74%	
3	Income Authorized Per Year (1*2)		\$ 13,880	\$ 80,880
4	Conversion Factor for Taxes		1.64	
5	Revenue Required from customers per year (3*4)		\$ 22,107	\$ 132,643

EXHIBIT SM-2

Exhibit SM-2

* These percentages were taken from the Mohave Water Districts pending case, Docket No. WS-01303A-14-0010. The Mohave district is the district currently operated by EWAZ that most closely resembles the Willow Valley district, in our opinion.

EXHIBIT SM-3

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman (Part 1)
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Response provided by: Greg Barber and Sarah Mahler (Part 2)
Title: Controller and Manager, Rates & Regulatory

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.08

Page 1 of 2

Q: Utility Plant in Service ("UPIS") – Please reconcile the following two UPIS amounts identified on the following two pages in the Original and Supplement to the Application below:

1. Original Application - Exhibit B on page 4 at the bottom line (Line not numbered) in the amount of \$2,785,645; and
2. Supplement to Application – Net Utility Plant in Service amount of \$2,796,377 on page 4 at line 6.

Please identify the source of the discrepancy between the amounts in 1 and 2 above, which is a difference of \$10,732. In addition, please provide the supporting accounting documentation that reconciles the difference.

- A:
1. The \$10,732 discrepancy between Original Application (Exhibit B, Page 4) and the Supplement to Application is due to the following (see schedule below):
 - a) \$19,767 of Construction Work in Process is not included in Plant in Service in the Original Application, but is included in Supplement to Application as EPCOR is paying value for this asset.
 - b) (\$8,255) of miscellaneous assets, including computer hardware/software and office furniture, Global Water and EWAZ agreed to exclude from the Purchase Price.
 - c) (\$780) of accumulated depreciation variance between Original Application and the Annual Report.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman (Part 1)
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Response provided by: Greg Barber and Sarah Mahler (Part 2)
Title: Controller and Manager, Rates & Regulatory

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.08

Page 2 of 2

Bridge from Original Application (Exhibit B Page 4) to Supplement to Application

Net PP&E per Original Application (Exhibit B Page 4)	\$2,785,645
Add: Construction Work in Process (CWIP)	\$19,767
Subtract: Miscellaneous assets excluded from purchase price	\$(8,256)
Subtract: Accumulated depreciation variance	\$(780)
Net PP&E per Supplement to Application	\$2,796,377

2. Please reference the table below for a reconciliation of the 2014 Willow Valley Annual report (Exhibit B, p. 4) and the final acquisition value contained in the Supplement to Application. During the due diligence process, the parties agreed to exclude certain assets from the Purchase Price. The amount of those assets can be found in the attachment to this response labeled "Assets Reconciliation.xls". The table copied below is also in that file.

Description	Willow Annual Report (Exh. B P 4.)	Accumulated Depreciation Difference	Total Adjusted Plant	Excluded Assets	CWIP	Final Plant Plant Value
Original Cost	\$ 5,168,988	\$ -	\$ 5,168,988	\$ (22,879)	\$ 19,767	\$ 5,165,876
Accumulated Depreciation	\$ (2,383,343)	\$ (780)	\$ (2,384,123)	\$ 14,624		\$ (2,369,499)
Net UPS	\$ 2,785,645	\$ (780)	\$ 2,784,865	\$ (8,255)	\$ 19,767	\$ 2,796,377

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

SUSAN BITTER SMITH - CHAIRMAN
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION) DOCKET NO. W-01732A-15-0131
OF WILLOW VALLEY WATER CO., INC. AND) DOCKET NO. W-01303A-15-0131
EPCOR WATER ARIZONA, INC. FOR)
APPROVAL OF THE SALE OF ASSETS AND)
TRANSFER OF CERTIFICATE OF)
CONVENIENCE AND NECESSITY)

Rebuttal Testimony of

Ron Fleming

on Behalf of

Willow Valley Water Co., Inc.

October 23, 2015

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1 **I. Introduction.**

2
3 **Q. Please state your name and business address.**

4 A. My name is Ron Fleming. My business address is 21410 North 19th Avenue, Suite 220,
5 Phoenix, Arizona 85027.
6

7 **Q. By whom are you employed and what is your position?**

8 A. I am employed by Global Water Resources, Inc. ("Global") as President and Chief
9 Executive Officer. In that capacity, I oversee the operations of our Arizona utilities,
10 including Willow Valley Water Co., Inc. ("Willow Valley").
11

12 **Q. Please describe your education.**

13 A. I earned my Bachelor of Science degree in Construction Management from School of
14 Engineering at Northern Arizona University in 2003. My emphasis was on Heavy Civil
15 Construction, with a minor in Business Administration.
16

17 **Q. Please describe your professional background and experience.**

18 A. From 2002 to 2004, I worked as a project manager and project engineer for general
19 contractors, supervising a number of significant projects. I joined Global as Senior Project
20 Manager (2004 – 2007), where I provided project management for Global's Maricopa
21 region. During this time, I directly oversaw Global's Capital Improvement Program for
22 Santa Cruz and Palo Verde while they were some of the fastest growing utilities in the
23 nation. In 2007, I was promoted to General Manager of the West Valley Region, where I
24 had direct responsibility for the five utilities Global acquired from the former owners of
25 West Maricopa Combine. From 2010 to December 2012, I was Global's General
26 Manager, Arizona, with direct responsibility for the operations of all of Global's utilities in
27 Arizona. In December 2012, ~~I was~~ I was promoted to President of the Regulated Utilities

1 Division of Global. I was promoted to President and Chief Operating Officer of Global in
2 June 2013, and I became Chief Executive Officer in January 2015.

3
4 I serve on the boards of the Maricopa Economic Development Alliance, the Pinal
5 Partnership, and WESTMARC. I also have co-chaired the Water Resources Committees
6 for the Pinal Partnership and WESTMARC. I am also a member of the board of Willow
7 Valley.

8
9 **Q. Have you previously testified before the Commission?**

10 A. Yes, I have testified or submitted written testimony in a number of Commission
11 proceedings, including:

- 12 • The recent CC&N hearing for Global Water – Santa Cruz Water Company (Docket
13 No. W-20446A-14-0290);
- 14 • Our last rate case. (Docket No. W-01212A-12-0309 et al.); and
- 15 • Arizona Water Company's SIB proceeding (Docket No. W-01445A-11-0310)

16
17 **Q. What topics will your testimony address?**

18 A. I will describe Global's concerns with certain proposals of Staff and RUCO. I will also
19 discuss the benefits of the proposed asset transfer to EPCOR Water Arizona (EWAZ). I
20 will provide an overview of Global's 2006 acquisition of Willow Valley, the numerous
21 problems faced by the Willow Valley at that time, and the extensive efforts Global
22 undertook to rehabilitate Willow Valley's system. Lastly, I describe the current state of
23 Willow Valley's distribution system and the status of Willow Valley's SIB program.

24
25
26 **Q. Is Global presenting the testimony of any other witnesses?**

27 A. Yes. Paul Walker will testify regarding regulatory policy issues concerning water utility

1 consolidation, as well as specifically addressing Staff and RUCO's proposals to create a
2 regulatory liability related to Accumulated Deferred Income Taxes ("ADIT").
3

4 **II. Concerns with Staff's and RUCO's recommendations.**
5

6 **Q. Did you review the Direct Testimony submitted by Staff and RUCO?**

7 A. Yes, I have reviewed the Direct Testimony of Staff's witnesses Gerald Becker and Jian
8 Liu, and RUCO's witness Jeffrey M. Michlik.
9

10 **Q. Do you have any concerns with the Staff and RUCO testimony?**

11 A. Yes. I believe that if the Commission adopts Staff's and RUCO's proposals, it will be
12 devastating to the cause of consolidation of water utilities in Arizona.
13

14 **Q. What aspect of their testimony concerns you most?**

15 A. Their proposal to create a regulatory liability for EWAZ in the amount of \$260,224 as an
16 offset to EWAZ's rate base. This is very significant in the context of Willow Valley's rate
17 base of approximately \$2.2 million, as contemplated in the Asset Purchase Agreement. An
18 11% reduction to rate base is significant; when also considering the fact that the ADIT
19 liability must still be accounted for by Global in future tax filings. This is akin to a double
20 accounting. If other companies face this issue of a significant cut to rate base due simply
21 to an asset sale, it will become very difficult to financially justify pursuing any such deals.
22 Mr. Walker will explain why this proposed regulatory liability should be rejected.
23

24 **Q. Are there any other issues that concern you?**

25 A. Yes. I take issue with Mr. Becker's statement that "Due to the state of the infrastructure at
26 Willow Valley and Global's failure to mitigate its water losses, Staff recommends that the
27 Commission be mindful not to create an incentive for those who fail to maintain water

1 systems to propose to sell those systems at an amount in excess of its rate base.” (Becker
2 Direct, page 4, line 23 to page 5, line 1).

3
4 This statement gives the wrong impression. Global certainly has not failed to maintain
5 Willow Valley. Indeed, Global invested approximately \$3.3 million into new
6 infrastructure for Willow Valley after the acquisition in 2006. Willow Valley has lost
7 money each year we have owned it. Even though Global has not earned a return on its
8 investment due to regulatory lag and a prolonged rate phase-in, it continued to invest
9 heavily in Willow Valley. The problem is simply the deplorable condition of the system
10 when we purchased it. There are certainly many more improvements that can be made, but
11 Global’s efforts to improve the system have been significant.

12
13 **Q. Do you agree with Mr. Becker’s implication that the purchase price is too high?**

14 **A.** Not at all. Not even considering the purchase price Global paid in 2006, Global invested
15 nearly \$3.3 million in capital improvements for Willow Valley. The purchase price under
16 the Asset Purchase Agreement is \$2,494,834, much less than Global has invested in this
17 Willow Valley.

18
19 **III. Benefits to customers of the asset transfer to EWAZ.**

20
21 **Q. Will the asset transfer benefit Willow Valley’s customers?**

22 **A.** Yes. Willow Valley is over 200 miles from Global’s headquarters in Phoenix, and even
23 farther from our main service areas in Pinal County. Currently, we only have three
24 employees located in Willow Valley, and any additional help is over 200 miles away. In
25 contrast, EWAZ has water systems only a few miles away. This means in any emergency
26 or outage event that requires resources beyond that of the direct personnel, that EWAZ can
27 provide a much quicker response with additional resources. In addition, having a pool of

1 nearby employees means that if a worker is on vacation or sick another employee can
2 easily be shifted over to cover.

3
4 Moreover, EWAZ should be able to realize economies of scale that will ultimately benefit
5 ratepayers. As Staff witness Mr. Liu explains, "EWAZ has a significant presence in the
6 Mohave County area which should result in economies of scale savings for Willow Valley
7 in the future." (Liu Direct, Exhibit JWL, page 1).

8
9 Willow Valley is a fairly small system, with approximately 1,600 customers. In contrast,
10 EWAZ's Mohave and North Mohave systems have approximately 19,000 customers.¹ The
11 reality is that while we are confident in the work and manner in which we improved and
12 currently operate Willow Valley, EWAZ can operate Willow Valley more effectively and
13 efficiently. That is not to say Global cannot get the job done; we are operating Willow
14 Valley in compliance with all regulatory requirements, and we will continue to do so if the
15 transaction is not approved by the Commission or if a closing does not occur. But the fact
16 of the matter is that EWAZ's larger local footprint gives it an advantage that we cannot
17 match locally; that is why the transaction makes sense for Global, EWAZ, and Willow
18 Valley's customers.

19
20 While Global has been able to successfully manage this system, and as the record shows,
21 dramatically improve the quality of the infrastructure and the service; it is also true that
22 proximity matters and EWAZ will be able to more easily oversee and manage the system.

23
24 **Q. Are there potential financial benefits to ratepayers?**

25 **A.** Yes. I have already explained that EWAZ will likely release operational efficiencies and

26
27 ¹ According to Decision No. 74174 (October 25, 2013), EWAZ's Mohave System had
approximately 17,000 customers, and the system acquired from North Mohave Valley Corporation
had approximately 2,000 customers.

1 economies of scale upon closing. In addition, as Mr. Becker explains, EWAZ "has a
2 capital structure that is more favorable to the ratepayers". (Becker Direct at page 10, line
3 9).

4
5 **Q. What about infrastructure improvements?**

6 A. As I understand it, EWAZ has pledged to invest \$1 million in infrastructure improvements
7 in Willow Valley (over and above the SIB projects), as part of its acquisition premium
8 proposal. Global has no plans for a similar program. In light of the many years of
9 financial losses experienced by Willow Valley, combined with having already plowed
10 nearly \$3.3 million into Willow Valley, with no return on this investment, we simply
11 cannot financially justify further investment on this scale in Willow Valley. Of course, if
12 Global retains ownership, we will continue to ensure that Willow Valley meets all
13 regulatory requirements and we will make the investments necessary for that to happen.
14 But the system could benefit from very significant investments, and EWAZ's \$1 million
15 would no doubt be very well spent. What EWAZ is proposing is a rapid advance and
16 escalation of investment into Willow Valley. This is going to result in a more rapid
17 approach to the attaining the goal that Global, EWAZ, and the Commission share: A
18 system operating at maximum performance with maximum efficiency for the benefit of the
19 customers.

20
21 **IV. Global's stewardship of Willow Valley.**

22
23 **Q. When did Global acquire Willow Valley?**

24 A. Willow Valley was part of the stock purchase of West Maricopa Combine ("WMC").

25
26 **Q. What was WMC?**

27 A. WMC was a holding company that owned five utilities: Valencia Water Company; Water

1 Utility of Greater Buckeye; Water Utility of Greater Tonopah (WUGT); Willow Valley
2 Water Co., Inc. and Water Utility of Northern Scottsdale. Global purchased WMC in the
3 summer of 2006. After Global took possession, we discovered numerous serious problems
4 in these companies, including Willow Valley.

5
6 **Q. Please explain some of the problems Global discovered upon buying WMC.**

7 A. The condition of WMC's systems was deplorable. There were rocks used to keep open
8 electrical breakers, and bungee cords were used to close high voltage electrical panels.
9 The Valencia system lacked adequate capacity, which required us in the first summer post-
10 acquisition to shut off service to large non-potable irrigation customers to ensure there was
11 sufficient water for homes. In certain areas, distribution systems were in very poor
12 condition, and many remain that way as it will require significant additional investments to
13 rectify.

14
15 WMC had taken some steps towards complying with the EPA arsenic standards, but
16 overall they were not prepared and could not secure the necessary funding. Some of the
17 treatment systems that they did design and install, functioned poorly. We upgraded them as
18 possible, but often it is impossible to dramatically improve poorly engineered and
19 constructed systems once in-place, as this would require total replacement. In other
20 locations, we had to scramble to design and install treatment systems to meet the EPA
21 arsenic requirements and fast approaching deadline to comply with the rule.

22
23 **Q. What about Willow Valley in particular?**

24 A. Willow Valley was the most troubling situation. We discovered that under the former
25 management, Willow Valley providing non-chlorinated drinking water in an unlooped
26 distribution system in an area that had a history of coliform events. This created a
27 significant public health risk. Former management concealed this situation by tampering

1 with water samples, and by filing false reports or failing to file necessary reports with the
2 relevant regulatory authorities. This situation was totally unacceptable.
3

4 **Q. What did Global do?**

5 A. We immediately began chlorinating the Willow Valley system. We then began a
6 significant effort to correct the severe water quality and infrastructure issues in Willow
7 Valley.
8

9 **Q. What other issues did Global discover?**

10 A. There were significant compliance problems. Under former management, WMC failed to
11 issue required public notices, failed to complete required Customer Confidence Reports
12 (CCRs), failed to adequately monitor their systems, and failed to file required reports.
13

14 **Q. What occurred when Global began chlorinating the water in Willow Valley?**

15 A. The chlorine reacted with the naturally occurring high levels of iron and manganese in the
16 water and deposits of these minerals that had built up overtime within the distribution
17 system due to lack of proper treatment – the result was the drinking water turned brown,
18 literally the color of Coca Cola.
19

20 **Q. What other issues did Global encounter in Willow Valley?**

21 A. The distribution system was in poor condition. The distribution system emplaced by
22 earlier owners was often found to be substandard. Because of the high iron and manganese
23 concentrations in the area's source water (that was not properly removed with beneficial
24 treatment techniques by prior owners), those pipes had become highly congested with iron
25 and manganese deposits. A 6" inch diameter pipe had a 2 – 3" usable space left within the
26 interior of the pipe. This also resulted in system pressure issues.
27

1 **Q. How did Global deal with this issue?**

2 A. First, you must start at the source as to eliminate the continued introduction of the minerals
3 into the distribution system. So in 2007 and 2008, Global built new iron and manganese
4 removal systems at the production facilities. This was part of a multi-year, multi-faceted
5 approach to eliminate the water aesthetic and quality issues. Here is an outline of the plan
6 that was executed:

- 7 ▪ Installed new chlorine injection systems that help ensure water is properly disinfected.
- 8 ▪ Installed auto-dialer alarm systems that notify our staff in the event there are
9 operational issues at our facilities. This helps prevent service outages.
- 10 ▪ Identified all existing water lines and performed Hydraulic Modeling to establish
11 distribution system performance. This assists in planning system improvements to
12 maximize benefits to the system as a whole.
- 13 ▪ Installed automatic flushing devices and operate an active flushing program to reduce
14 the built up iron and manganese accretion in the water pipelines.
- 15 ▪ Completed the Unit 17 Water Distribution Center (WDC) Improvement Project. The
16 project included a new iron and manganese removal system along with a new water
17 source, and complete electrical/mechanical upgrades. These new facilities have
18 improved water clarity and reliability of service.
- 19 ▪ Completed the Cimmaron WDC Improvement Project. The project included complete
20 site improvements and upgrades to the existing iron and manganese removal systems
21 and electrical/mechanical systems. These rehabilitated facilities will improve water
22 clarity and service reliability for the Cimmaron Development.
- 23 ▪ Installed new control valves in strategic areas as to improve our ability to re-direct
24 water, isolate line breaks, and reduce the number of customers affected by failures.
- 25 ▪ Finally, recently we completed additional treatment upgrades to address the remaining
26 water aesthetic and compliance issues, as discussed below.

1 Beyond these improvements that were required immediately, it remains clear that the
2 remaining pipeline system must be replaced. Willow Valley will need to install new water
3 mains, water line loops, and install new valves where needed to eliminate frequent line
4 failures and to improve service reliability.

5
6 Additionally, as one important element of addressing water loss issues and to improve
7 customer service and staff safety concerns (meters in Willow Valley are mostly located in
8 the backyards of customers which historically required utility personnel to access back
9 yards which is never a good situation if it can be prevented), in 2010 Global replaced each
10 and every customer meter with a new Neptune meter and a Fixed Network Meter reading
11 system. This advanced system allows Global to continuously read customer usage from
12 remote locations for billing, customer inquiry, and troubleshooting activities. The system
13 also includes leak detection and other abnormal usage alert capabilities. In addition to
14 these benefits, it greatly reduced the need to access utility meters through customer
15 property.

16
17 **Q. What other improvements did Global make to Willow Valley's treatment and**
18 **production systems?**

19 A. Ongoing issues in the Willow Valley system required a number of treatment upgrades. In
20 December 2011, Willow Valley completed chlorine dioxide generator facility
21 improvements to the Unit-17 and Cimarron water production sites, as well as instituting a
22 corrosion control chemical system. The treatment upgrades were necessary to ensure that
23 the systems meet the requirements of EPA's Lead and Copper Rule, as well as
24 Disinfectants and Disinfection By-Products rules.

25
26 **Q. Why were these improvements needed?**

27 A. As already noted, when Global acquired the Willow Valley system in the summer of 2006,

1 the system was in poor shape and was not chlorinated. Chlorination is standard practice
2 for Global Water in order to protect public health, and so chlorination was initiated
3 immediately, which in turn resulted in immediate water aesthetic issues.
4

5 As chlorine can act as both a disinfectant and oxidant, the Willow Valley system has
6 experienced a number of challenging water quality issues associated with oxidation of high
7 concentrations of iron, manganese and total organic carbon (TOC) levels in the source
8 water. In order to address the original water quality challenges related to discoloration due
9 to the reaction of high concentrations of iron and manganese with chlorine,
10 oxidation/filtration units were installed at the groundwater sources in 2007 and 2008.
11 Additionally, in 2009, the Federal Environmental Protection Agency (EPA) enacted the
12 Groundwater Rule of the Safe Water Drinking Act (SWDA). In response to the
13 requirements of this rule, Global installed continuous monitoring to ensure the necessary
14 chlorine residual is maintained at all times.
15

16 Although aesthetic water quality was improved, compliance issues related to copper
17 corrosion and high total trihalomethane formations resulted. To resolve these issues, in
18 2010 a corrosion control study was conducted. This study concluded water corrosion
19 chemistry can be affected by groundwater treatment techniques. In the case of Willow
20 Valley, incidental cuprosolvency (copper solvency) is caused by a number of factors
21 related to the treatment and disinfection of groundwater. For this system, slow oxidation
22 reactions due to organically bound metal compounds caused by high levels of TOC in the
23 raw water source, are caused by extended use of oxidants related to iron and manganese
24 removal. Coupled with the incidental aeration and increased Dissolved Inorganic Carbon
25 (DIC) concentrations related to the iron and manganese filtration process, these factors are
26 the leading causes of increased copper solvency of the water. To offset cuprosolvency
27

1 effects of the water in the Willow Valley distribution system, the following improvements
2 were required to be implemented:

- 3 • Oxidant levels must be managed in the distribution system.
- 4 • Oxidant levels must be managed in the pretreatment process of the iron and
5 manganese filtration process.
- 6 • TOC compounds must be oxidized and removed prior to disinfectant application.
- 7 • Chlorine compounds must be managed in the distribution system.
- 8 • Chloride compounds must be reduced to allow alkaline components to provide
9 naturally occurring protective films between the contact water and exposed metal
piping.

10 These areas were effectively addressed utilizing the following process changes and/or
11 capital improvements:

- 12 • Add oxygen scavenging inhibitors to reduce available dissolved oxygen and in
13 turn, reduce oxidation potential of the contact water.
- 14 • Change pre-oxidant chemical for TOC, iron and manganese removal to non-
15 chlorine base oxidant.
- 16 • Improve pre-oxidation techniques by adding in-line static mixers to improve
oxidation efficiency.
- 17 • Move chlorine disinfectant to the discharge side of the pressure boosting station.
18 Improve disinfectant dispersion by adding an in-line static mixer to the booster
station discharge piping.
- 19 • Add corrosion control chemicals to offset damage to naturally occurring protective
20 films from excessive chloride and sulfate concentrations, and sequester iron and
manganese concentrations in the finished water.
- 21 • Reduce pre-oxidant requirements and improve TOC, iron and manganese removal
22 through the addition of manganese dioxide, manganese greensands or other filter
media as required per site.
- 23 • Remove excessive chloride and/or sulfate levels of the source water through
24 additional treatment techniques.

25 These recommendations led to bench scale piloting of alternative oxidants in 2011
26 including chlorine dioxide, and potassium permanganate, as well as corrosion control using
27 two polyphosphates which were evaluated to resolve the water quality issues.

1 Additionally, a field pilot study included:

- 2 • THM Control – Alternative liquid chlorine dioxide oxidant system replacing the
- 3 sodium hypochlorite oxidant;
- 4 • Disinfection control - chlorine gas replacing the sodium hypochlorite disinfectant
- 5 system;
- 6 • Corrosion control – Tetrasodium Pyrophosphate Corrosion inhibiting chemical feed
- 7 systems; and
- 8 • Solids Handling – Incorporate cone bottom settling tanks to improve solids capture.

9 The following summarizes the documented water quality results of the resultant
10 installation of chlorine dioxide generator facility improvements to the Unit-17 and
11 Cimarron water production sites completed in December of 2011.

- 12 • Total copper levels in the King Street Distribution System decreasing by as much
- 13 as 61%, and all lead and copper samples conducted in 2011 and 2012 indicate
- 14 compliance with regulatory standards.
- 15 • Total copper levels in the Cimarron Distribution System decreasing by as much as
- 16 65%, and all lead and copper samples conducted in 2011 and 2012 indicate
- 17 compliance with regulatory standards.
- 18 • Total Organic Carbon (TOC) levels decreasing by as much as 11%
- 19 • Total Trihalomethane (TTHM) levels decreasing by as much as 41%, and all
- 20 samples throughout the pilot program and in 2011 and 2012 indicate compliance
- 21 with regulatory standards
- 22 • Iron removal - average of 98.8%.
- 23 • Manganese removal - average greater than 85%.

24 Since completion of these improvements, Willow Valley has been in full regulatory
25 compliance.

26 **Q. Overall, how much as Global invested in Willow Valley since it was acquired?**

27 **A.** From the purchase of WMC in the summer of 2006, through June 18, 2015, Global
invested \$3,296,326.63 in plant investments for the Willow Valley system.

1 **V. Update on distribution system and SIB mechanism.**

2
3 **Q. What about the distribution system?**

4 A. Due to the issues described above, Global focused on the urgently needed improvements to
5 the production and treatment systems. Significant issues remain with the distribution
6 system.

7
8 **Q. Have there been any studies on what improvements would be beneficial?**

9 A. Yes, Global utilized a WIFA technical grant to study the Willow Valley distribution
10 system. This study helped prioritize the areas that most needed and would provide the
11 most benefit if replaced first. A copy of the study was attached as Attachment Fleming-3
12 to my Direct Testimony in our 2012 rate case. Overall, the study determined virtually all
13 pipelines (except for those in the smaller, newer residential development of Cimarron
14 Estates) needed to be replaced through an ongoing replacement program. Global estimates
15 the cost of main replacement program could reach \$5 million.

16
17 **Q. What about the SIB Mechanism?**

18 A. Global was part of the process of developing the original SIB Mechanism in Docket No.
19 W-01445A-11-0310. We proposed a SIB Mechanism in our 2012 rate case. In the rate
20 case, we submitted the "Willow Valley Water Company Water System Engineering Report
21 for System Improvement Benefit (SIB) August 2013". This 40+ page engineering report
22 included system maps, detailed engineering plans, and SIB plant tables for the proposed
23 SIB projects, which were our highest priority distribution system projects.

24
25 **Q. Have any SIB projects been completed in Willow Valley?**

26 A. No. After the Commission approved the SIB Mechanism (which didn't occur until
27 February of 2014), Global began additional engineering and pre-construction work,

1 focusing on Project #1 for the SIB—Gordon Street Waterline. Willow Valley's
2 Engineering and Construction Staff conducted a thorough on-site data collection effort and
3 concluded the finite details of the project—including the service lateral installation
4 locations for each individual customer. During this on-site effort, Willow Valley's staff
5 contacted and met with the appropriate City and County agencies to discuss the details of
6 the projects, obtain the required construction specifications, and determine the necessary
7 permitting processes. The team compiled this information and hired an engineering firm to
8 produce the detailed construction drawings—which were completed in late 2014. These
9 drawings will be submitted to a list of pre-selected contractors to obtain bids and award a
10 contract for construction.

11
12 **Q. Why have not SIB projects been constructed in Willow Valley?**

13 A. The original plan was to implement the first SIB project in 2015. However, ongoing
14 litigation by RUCO with the ACC pertaining to SIBs created a risk that the SIB
15 Mechanism would not operate as designed. In addition, as the Asset Purchase Agreement
16 with EWAZ was negotiated, the parties made the determination that where possible, it
17 would be best -to put a hold on stop all major capital projects as it was determined best for
18 the utility, its customers, and the Commission that these be implemented by the ultimate
19 utility owner. However, under the Asset Purchase Agreement, Global does retain the
20 option of proceeding with needed capital projects after notifying EWAZ. In practice, we
21 would confer with EWAZ to see if we could reach consensus as to whether to begin a
22 capital project or wait for EWAZ to assume ownership.

23
24 **Q. What is the current status of Willow Valley's SIB mechanism?**

25 A. On October 20, 2015, the Commission voted to stay all of the SIB mechanisms, including
26 Willow Valley's, in light of a recent Arizona Court of Appeals decision. I understand that
27 the Commission has asked the Arizona Supreme Court to review the matter.

1 **Q. Please summarize your testimony.**

2 A. Global has invested heavily in Willow Valley, but it's true that more needs to be done.
3 Global has been direct about this throughout the prior rate cases, and this docket. EWAZ is
4 in a better position to make those investments. EWAZ has a much larger local presence,
5 and upon closing, EWAZ should be able to achieve operational efficiencies and economies
6 of scale. Moreover, EWAZ has a lower cost of capital.

7

8 Staff's and RUCO's proposed "regulatory liability" for ADIT should be formally rejected.
9 It will create a strong disincentive for future consolidation. I urge you to review Mr.
10 Walker's testimony in this regard.

11

12 **Q. Does this conclude your testimony?**

13 A. Yes.

14

15

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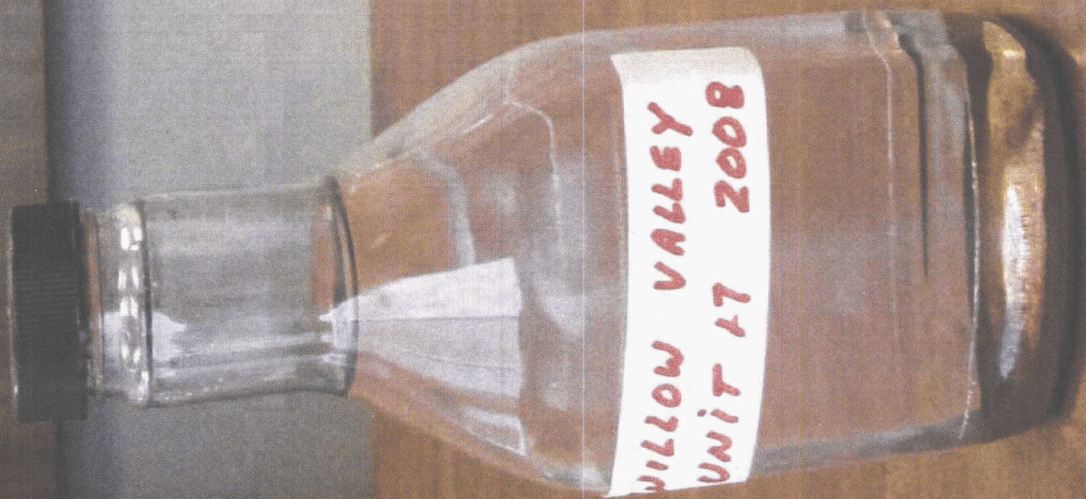
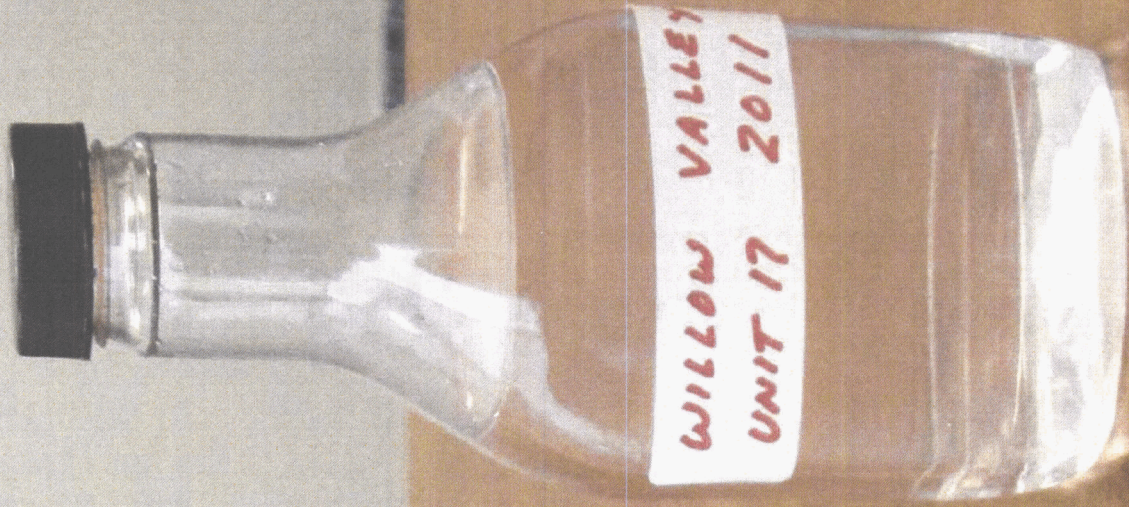
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EXHIBIT

Willow-2
ADMITTED

tabbies



EXHIBIT

tabbies

Willow-3
ADMITTED



EXHIBIT

Willow-4
ADMITTED

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EXHIBIT

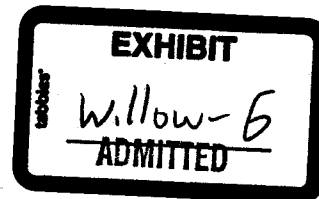
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WILLOW-S
ADMITTED

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 **COMMISSIONERS**

3 SUSAN BITTER SMITH - CHAIRMAN
4 BOB STUMP
5 BOB BURNS
6 DOUG LITTLE
7 TOM FORESE



8 IN THE MATTER OF THE JOINT APPLICATION) DOCKET NO. W-01732A-15-0131
9 OF WILLOW VALLEY WATER CO., INC. AND) DOCKET NO. W-01303A-15-0131
10 EPCOR WATER ARIZONA, INC. FOR)
11 APPROVAL OF THE SALE OF ASSETS AND)
12 TRANSFER OF CERTIFICATE OF)
13 CONVENIENCE AND NECESSITY)

14
15 Rebuttal Testimony of

16 Paul Walker

17 on Behalf of

18 Willow Valley Water Co., Inc.

19
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21 October 23, 2015
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1 **I. Introduction.**

2
3 **Q. Please state your name and business address.**

4 A. My name is Paul Walker. My business address is 330 East Thomas Road, Phoenix,
5 Arizona 85012.
6

7 **Q. By whom are you employed and what is your position?**

8 A. I am the founder, owner and President of Insight Consulting, LLC.
9

10 **Q. Please describe your education.**

11 A. I have a Master's Degree in Business Administration from the Thunderbird School of
12 Global Management. I have a Bachelor's Degree in Business Management from the
13 University of Phoenix. I am a graduate of numerous U.S. Army schools, including the
14 U.S. Army War College's Combined Arms and Service School, the U.S. Army Officer
15 Advanced Course (Transportation), and the U.S. Army Officer Basic Course (Military
16 Police).
17

18 **Q. Please describe your professional background and experience.**

19 A. From 2004 to present I have worked as a lobbyist and regulatory consultant for clients in
20 the utility and energy sectors. I worked with Wall Street investment firms from 2004 to
21 2009, conducting regulatory analysis of federal and state matters ranging from rate cases
22 in numerous states, and evaluating liquefied natural gas export terminal feasibility. I
23 have worked with several Arizona utilities, including Arizona Public Service, Tucson
24 Electric Power, Arizona Water Company, Liberty Utilities, and, of course, Global Water
25 Resources. Prior to that, I served as advisor to Commissioner Marc Spitzer at the
26 Arizona Corporation Commission, and on Governor Jane Dee Hull's Indian Gaming
27

1 compact negotiation team. I have also served on the Commission's Power Plant and Line
2 Siting Committee.

3
4 **Q. Have you previously testified before the Commission?**

5 A. Yes, I have provided testimony in a number of Commission proceedings on issues such
6 as regulatory policy, water utility acquisitions, utility financial issues, the System
7 Improvement Benefit ("SIB") mechanism, and other topics. Dockets where I have
8 testified or submitted written testimony include:

- 9 • Arizona Water Company's SIB proceeding (Docket No. W-01445A-11-0310);
- 10 • Global Water's last rate case (Docket No. W-01212A-12-0309 et al.); and
- 11 • Arizona Water Company's Application to Extend its CC&N (Docket No. W-
12 01445A-03-0559)

13 I have also given numerous presentations at regulatory workshops and industry meetings.

14
15 **Q. Please provide an overview of your testimony.**

16 A. I will rebut Staff's and RUCO's unwarranted and unprecedented proposal to create a
17 "regulatory liability" for Accumulated Deferred Income Taxes ("ADIT"). I explain that
18 this proposal should be rejected because:

- 19 • It is unprecedented and contrary to normal accounting;
- 20 • It is very poor policy, making utility consolidation much more difficult;
- 21 • It fails to recognize the tax consequences of the asset sale; and
- 22 • It also appears to violate federal tax normalization rules, which could result
23 in serious negative consequences for EWAZ's ratepayers.

24 In addition, my testimony will describe the benefits of consolidation in the water utility
25 industry, and then will describe some of the policy options available to the Commission. I
26 will also respond to Mr. Michlik's and Mr. Becker's testimony on acquisition issues.

1 **II. Proposed regulatory liability for ADIT.**

2
3 **Q. What is ADIT and how does it impact rate base?**

4 A. ADIT occurs due to differences between regulatory and tax accounting. The primary
5 difference is in depreciation. For regulatory purposes, straight line depreciation is used,
6 while accelerated depreciation may be taken in certain tax situations. This creates a
7 temporary tax benefit to the utility, which is reversed over time as regulatory depreciation
8 catches up to the accelerated tax depreciation. This temporary tax benefit is referred to as
9 ADIT. For regulatory purposes, ADIT is considered a non-investor supplied source of
10 capital, and is thus treated as a reduction to rate base.

11
12 **Q. What happens to ADIT in an asset sale?**

13 A. Because the ADIT relates to the income taxes of the seller, it remains with the seller. No
14 ADIT is carried over to the buyer, although the buyer will begin recording new ADIT after
15 the purchase.

16
17 However, because the seller no longer owns the assets that generate the depreciation, the
18 taxes are no longer deferred; the regulatory and tax differences are trued up. In other
19 words, the previously deferred taxes become due.

20
21 Thus, ultimately, the ADIT will no longer exist, for either the seller or the buyer. Because
22 the ADIT will not exist, it is not appropriate to recognize it for ratemaking purposes.
23 Staff's and RUCO's proposed "regulatory liability", in essence, means pretending that
24 ADIT still exists when it does not.

25
26 In my experience, "pretending" and "accounting" are not things that go well together.
27 Ratemaking should reflect economic realities, and the reality is that these taxes will no

1 longer be deferred.

2
3 **Q. What about Staff's and RUCO's argument that the loss of the ADIT will harm**
4 **ratepayers?**

5 A. Their analysis is incomplete and speculative. ADIT will not be the only thing to change.
6 For example, as Mr. Becker notes, "EWAZ has a capital structure that is more favorable to
7 the ratepayers." (Becker Direct at page 10, line 9). Mr. Becker calculates the value of this
8 change as \$29,000 per year. In addition, the "value" of the regulatory liability of as an
9 offset to rate base will be lower due to EWAZ's lower cost of capital

10
11 As Mr. Liu and Mr. Fleming testify, the Willow Valley system should also benefit from
12 economies of scale under EWAZ's ownership. Certainly, there will be less need to make
13 the eight hour round trip from the Phoenix metro area to Willow Valley, given that EWAZ
14 has a large operation with a number of employees in the Mohave County region.

15
16 **Q. What are the policy implications of the proposed regulatory liability?**

17 A. The regulatory liability is very poor policy. That recommendation will not only end this
18 transaction, it will establish a phenomenally high level of regulatory uncertainty that will
19 make consolidating Arizona's water industry impossible

20
21 **Q. That's a strong statement. Please explain.**

22 A. What Staff and RUCO are proposing is unprecedented—they are proposing to take a tax-
23 related liability from one company and assign it to another company as a condition of
24 acquisition. If this is upheld by the Commission everyone looking at purchasing an
25 existing, ongoing entity will have to consider that every potential liability will be included,
26 by regulatory fiat. In this transaction, we have an asset sale. Yet Staff and RUCO are
27 proposing to go beyond the assets and into the stock ownership and assign a liability from

1 the stockholders of the selling entity to the stockholders of the purchasing entity.

2
3 **Q. How could creating a regulatory liability discourage water utility consolidation?**

4 A. As Mr. Fleming explains, the regulatory liability will significantly reduce rate base. And if
5 rate base is significantly reduced each time a utility is sold, there will be significant
6 disincentive for acquisitions of water utilities. Because the rate base will be higher before
7 the sale than after, the utility will be more valuable in the current owner's hands—even if
8 the current owner has difficulties providing service, lacks access to capital, and is lacking
9 in the technical and engineering areas. Basically, if this proposal is adopted, the
10 Commission will be sending a strong message to both potential buyers of water utilities
11 (including troubled water utilities), and sellers of water utilities, and that message will be
12 “**don't buy any utilities**” or “**don't sell your water utility**”. That is not the message the
13 Commission should send.

14
15 Moreover, it would be a precedent that is interpreted to mean much more than ADIT.
16 Water companies watch every major decision of the Corporation Commission to determine
17 the regulatory environment. If the Staff and RUCO recommendation is upheld, water
18 companies will certainly recognize that the Commission is going to go into every proposed
19 acquisition with an eye toward stripping value from the deal. What next? Staff and RUCO
20 are experts at many things, one of those things is finding ways to reduce rate base. But if
21 that approach is rolled into acquisitions, then acquisitions will never occur.

22
23 **Q. Is there any precedent for the proposed regulatory liability?**

24 A. I am not aware of any case where such a regulatory liability has been created.

25
26 **Q. Are there other issues with the proposed “regulatory liability” regarding ADIT?**

27 A. Yes, it may create serious tax risks that could harm ratepayers. A similar situation

1 occurred in an asset sale in Nebraska. The Nebraska Staff recommended transferring the
2 ADIT from a prior owner to the new owner. That raised serious tax questions. Before I
3 explain, let me issue the standard caveat: I am not an attorney, nor am I a tax accountant.
4 I am not opining on the tax consequences raised by the forced transfer of ADIT from one
5 owner to another—but with my experience assessing regulatory risk for Wall Street
6 firms, and with advising utilities on regulatory risk, and with my experience in utility
7 acquisitions, I find this to be a serious issue the Commission must consider.

8
9 The Nebraska company's witness, Mr. Lovinger, appears to be highly knowledgeable on
10 this issue and explained that the ADIT issue would violate IRS tax normalization rules.
11 A copy of this testimony is attached as Attachment Walker-1.

12
13 He explained that, "if the regulators were to require a flow-through of tax benefits or use
14 the prior owner's ADIT balance in the computation of rate base, this act would cause a
15 violation of IRS regulations and the utility would be prevented from computing
16 accelerated depreciation pursuant to IRC Section 168. As a result, ratepayers would pay
17 higher rates in the future due to the increase in rate base caused by the loss of accelerated
18 tax depreciation. Further, the utility would need to raise additional capital since it could
19 not count on interest free loans generated from the use of accelerated tax depreciation."
20 (Lovinger Testimony at page 12).

21
22 **Q. Do other authorities address the issue?**

23 **A.** Yes. Both the second edition of Professor Bonbright's *Principles of Public Utility Rates*
24 (1988)(under the heading "Normalization verses Flow-Through of Accelerated
25 Depreciation Tax Benefits", pages 286 to 290) and Professor Charles F. Phillips, Jr.'s *The*
26 *Regulation of Public Utilities* (1984)(under the heading "Interperiod Income Tax
27 Allocation," pages 267 to 273) discuss the historical debate between the flow through

1 method and the normalization method, and how the normalization method became
2 standard due to Congressional action restricting the flow through method by prohibiting
3 utilities from taking accelerated depreciation unless normalization is used. Copies are
4 included as Attachment Walker-2 (Bonbright) and Attachment Walker-3 (Phillips).

5
6 **Q. Are you testifying that Mr. Lovinger is correct?**

7 A. Again, I'm not a tax expert. But as a matter of regulatory policy, I am testifying that the
8 Commission should fully vet this issue and understand the consequences to EWAZ and
9 its ratepayers before considering creating a regulatory liability for ADIT. Staff's and
10 RUCO's testimony do not address the tax normalization issue.

11
12 **Q. Please summarize your testimony on the proposed regulatory liability for ADIT.**

13 A. The Commission should firmly reject the proposed regulatory liability. The proposal is
14 unprecedented, and if adopted, would make future consolidation very difficult if not
15 impossible. Moreover, the proposed regulatory liability does not reflect the economic
16 reality that the tax deferral ceases upon the asset sale.

17
18 **III. Benefits of Consolidation of Water Companies.**

19
20 **Q. Why is consolidation of water companies important?**

21 A. Arizona water utility sector is highly fragmented. While there are a few large,
22 sophisticated entities, the vast majority are small operations with limited technical,
23 managerial or financial capabilities. Arizona's multitude of small utilities are a constant
24 source of problems. Some fail spectacularly, causing massive Commission involvement
25 to clean up the mess – often requiring more capable utilities like Global to assume the
26 role of "interim manager". Others are time bombs waiting to go off – just one failed
27 pump, ruptured tank or broken main away from collapse and without the resources to

1 respond to any problems. Still others limp along, lacking resources, expertise and
2 economies of scale. Moreover, small utilities lack the capacity to build the regional
3 infrastructure needed for sustainable water use and reuse. Similarly, many of the small
4 water systems have difficulties meeting current drinking water regulations, and many
5 more would be hard pressed to comply with new federal mandates.

6
7 **Q. What benefits can larger companies provide?**

8 A. Larger companies simply have more resources, with engineers, accountants and other
9 professionals on staff. Larger companies typically will have much better access to
10 capital, with the potential to raise debt capital by issuing bonds, as well as term loans or
11 lines of credit with major financial institutions. The same is true for equity capital; large
12 companies may raise equity capital directly through the capital markets if they are
13 publicly traded, or indirectly from parent entities or private investors.

14
15 **Q. Are there other potential benefits to consolidation by a larger utility?**

16 A. Yes. Depending on the location of the acquired utility, there may be additional benefits if
17 the purchasing utility has a system nearby. For example, a utility with a large system
18 nearby could potentially interconnect the smaller company into its system. Or perhaps in
19 the longer term, the smaller system could be included in future regional infrastructure
20 projects. And even if the systems are not physically interconnected, there will be
21 economies of scale from being part of a larger operation. For example, a single regional
22 supervisor could oversee both the existing system and the smaller system. Another
23 example is that the customers of the smaller system could have access to a call center,
24 which could offer longer hours of operation, at a lower cost, than a single customer
25 service representative for a small system.

1 **IV. Policies that can encourage consolidation.**

2
3 **Q. Are there policies that can support consolidation?**

4 A. Yes, there are numerous policies that could support consolidation. Some examples
5 include acquisition adjustments, ROE adders, and allowing developers to pay for
6 consolidation through ICFA agreements. There are many regulatory tools that can be
7 tried. The problem is not the lack of tools, it is that the tools have stayed in the toolbox
8 for decades.

9
10 **Q. You said that these tools have stayed in the toolbox. Please explain.**

11 A. We have been talking about promoting consolidation through acquisitions for many
12 years, but very little action has been taken. For example, in Global's 2009 rate case,
13 Staff's witness, Linda Jaress, testified that acquisition adjustments were a policy tool that
14 could be used to promote acquisitions.¹ But she testified that since the early 1990's, she
15 was aware of only two instances where the "policy tool" of acquisition adjustments were
16 the Commission approved.² She also testified that "the Commission has a long practice
17 of not allowing acquisition adjustments"³.

18
19 Similarly, in that case, the Staff recommended against using ICFAs as a means of having
20 developers pay for consolidation; instead Staff recommended and the Commission
21 approved treating approximately \$60 million of developer money spent on acquisitions as
22 CIAC. In Global's 2012 rate case, the CIAC imputation was reversed, but Global was
23 prohibited from ever using ICFAs again.

24
25
26

¹ Hearing Transcript, page 788, Docket No. SW-20445A-09-0077 et al.

27 ² Hearing Transcript, page 788 to 790, Docket No. SW-20445A-09-0077 et al.

³ Hearing Transcript, page 792, Docket No. SW-20445A-09-0077 et al.

1 **Q. Mr. Michlik refers to the 2001 Staff Proposed Policy on Acquisitions. How do you**
2 **respond?**

3 A. That proposal was part of the Commission's 1999 Water Task Force. I am shocked that
4 Mr. Michlik referred to the proposed policy favorably. Frankly, the 1999 Water Task
5 Force was a disaster as a policy initiative. A huge amount of effort went into the Task
6 Force, both from the Staff and the industry. The Water Task Force came up with many
7 good ideas, but few of them were ever implemented. The Staff Proposed Policy was never
8 adopted by the Commission. The Task Force Report recognized the need for changes in
9 Arizona's regulatory system, but those changes never came.

10
11 **Q. Mr. Michlik also refers to the RUCO / Responsible Water White Paper on**
12 **Acquisitions. How do you respond?**

13 A. As a co-author of the report (with Pat Quinn when he was RUCO Director), I am proud of
14 the work we did. But this too was a complete failure. RUCO backed out of the report, and
15 the recommendations in the report have not been adopted.

16
17 Furthermore, Mr. Michlick was careful to only cite the portions of the white paper that
18 bolstered his argument. I would like to bring the Commission's attention to other
19 portions of the white paper that do support the policy reasons that support the acquisition
20 and EWAZ's proposal to enact a new approach, a new tool, for incenting consolidation.

21
22 **Q. What portions of the white paper that you co-authored with Mr. Quinn support the**
23 **acquisition and EWAZ's recommended approach to dealing with the acquisition**
24 **premium?**

25 A. First and foremost, in Section One: The Policy and Factual Landscape of Arizona Water
26 states that there are three major forces that confront the Arizona water industry:
27 Economic Facts, Environmental Reality, and Regulatory Principles. Mr. Quinn and I

1 explain that those three forces have an interplay with each other – economic facts and
2 choices shape regulatory policy, environmental reality shapes regulatory policy and
3 affects economic facts. The three major forces all work in relation to each other,
4 constantly, to define the world for Arizona water companies.

5
6 **Q. What economic facts did you discuss in the paper as having an effect on**
7 **consolidating the industry?**

8 A. Economies of Scale and Small Firm Capital Attraction challenges are persistent
9 economic facts that affect the long-stated policy goal of the Corporation Commission to
10 incent and encourage the consolidation of Arizona's highly fragmented water industry.

11
12 **Q. How does Economies of Scale relate to the proposed transaction between EWAZ**
13 **and Global Water?**

14 A. In the discussion of Economies of Scale, we wrote: "A utility requires not just the day-to-
15 day operational staff; it also requires a management team to oversee the accounting,
16 capital improvement plans, financing, environmental compliance and reporting, human
17 resources, and investor relations."⁴

18
19 In this transaction, the management team that will oversee the capital improvement plans
20 and projects of Willow Valley will be located much closer to Willow Valley. While it is
21 true that the other elements of Economies of Scale are largely distance indifferent, when
22 it comes to overseeing construction there is no substitute for "boots on the ground".
23 EWAZ has operations within a few miles of Willow Valley, Global's management is
24 located 200 miles away. By no means am I suggesting that Global cannot oversee
25 construction projects, but it is indisputably true that EWAZ will be able to react to and
26 travel to construction challenges and sites much, much more quickly and easily than

27

⁴ Page 6

1 Global. This benefits customers because if and when problems arise, EWAZ will be able
2 to put "boots on the ground" almost immediately. And with the looming infrastructure
3 needs and the scope of the construction required in Willow Valley, that will matter.
4

5 **Q. How does Small Firm Capital Attraction Challenges relate to this transaction?**

6 A. Global has already invested over \$3 million into the Willow Valley system, as Mr.
7 Fleming explains in his testimony. This investment has had an incredible impact in
8 improving the system for the customers. Yet, as Mr. Fleming also explains, the
9 distribution system itself is in need of significant capital investment. EWAZ proposes, in
10 this transaction, to invest \$1 million into Willow Valley to address this need – as a result
11 of EWAZ's proposal, Willow Valley will be able to address and resolve that challenge
12 much more quickly.
13

14 **Q. The second "major force" that you and Mr. Quinn described was "Regulatory
15 Principles", how does that section of the white paper relate to this transaction?**

16 A. We wrote that "There are three key regulatory principles that must be strictly adhered to
17 should Arizona move forward with a policy and incentives to encourage consolidation of
18 the Arizona water and wastewater industry: Cost Causation, the Equity Principle, and
19 Sustainability."⁵
20

21 **Q. How does the issue of Cost Causation relate to this transaction?**

22 A. We then wrote, "The reality is this: Consolidations and Acquisitions come with costs –
23 and those costs must be recovered in a fair and manageable manner...Investors and
24 customers are, quite literally, in the same position here: Both can benefit from a stronger,
25 more consolidated industry, the key is to understand how to balance these costs."⁶
26

27 ⁵ Page 8

⁶ Ibid

1 In the transaction, the acquisition price reflects a premium that cost is real, EWAZ will
2 have to pay Global more than the book value of Willow Valley. For the customers to
3 gain the benefits of management more proximate and a \$1 million program of
4 improvements to be enacted in the near term, the acquisition premium is a real cost.
5

6 **Q. Do the other principles relate to this transaction, i.e., the Equity Principle and**
7 **Sustainability?**

8 A. They do tie in as we describe in the following section: "If done correctly, establishing a
9 consolidation enabling framework for Arizona water companies will integrate these three
10 principles in a more holistic way. First, the true cost of one's water system may be hidden
11 from customers if needed upgrades are not made or systems are neglected. Second,
12 equity is a principle that is dependent on one's time horizon. In the medium to long run,
13 the consolidation of two water systems may bring resiliencies and efficiencies that
14 overcome short run inequities. Third, sustainability comes when the true long run costs of
15 operating a successful water system are recovered and allocated within a system that is
16 resilient and efficient. Smart consolidation between companies should leverage all three
17 of these principles in a way that delivers long-term net benefits to all ratepayers
18 involved."
19

20 EWAZ's proposal to invest \$1 million in the near term will result in beneficial upgrades
21 for the customers; in the medium to long term the consolidation and proximity of
22 EWAZ's existing systems should bring resiliencies in staffing and efficiencies in
23 management; and the result will be a system that is more resilient and efficient.
24
25
26
27

1 **Q. The final “major force” that you and Mr. Quinn wrote about was Environmental**
2 **Reality. How does that relate to this transaction?**

3 A. In our white paper we cautioned against viewing consolidation as a “least cost” option –
4 in the long term, it will be the least cost. But in the near term, we wrote that “While
5 economies of scaled [sic] will provide downward pressure on prices and rates, it must be
6 clearly understood that consolidating and strengthening Arizona’s water infrastructure
7 will be a massively expensive effort that will take decades. So, economies of scale and
8 consolidation will not result in decreasing rates in the near term – they will only provide
9 downward pressure as Arizona deals with, and invests in, its 21st Century water
10 challenge. Drought, volatile and diminished Colorado River supplies, desalination,
11 reclaimed water and increased monitoring and conservation efforts are each costly, and
12 all necessary and prudent to secure Arizona’s water future.”

13
14 **Q. Likewise, Mr. Michlik brings up the March 19, 2012 Staff Report in the generic water**
15 **financing docket. Please respond.**

16 A. This report was the result of a series of workshops that the Commission ordered in
17 Decision No. 71878, the order in Global’s 2009 rate case. Workshops were held in 2011.
18 Again a great deal of industry and Staff effort went into this process. And again there was
19 no result. The Staff Report acknowledges that acquisition adjustments can be an
20 appropriate policy tool, yet it notes that only two have been approved by the Commission.
21 [Report at page 3]. Again a report has been produced, only to gather dust on the
22 bookshelves.

23
24 **Q. What about the specific limits on acquisition adjustments proposed in the Staff**
25 **Report?**

26 A. These seem quite restrictive. In particular, the requirement to wait for a rate case to find
27 out whether an acquisition adjustment has been approved does not seem appropriate. In

1 many cases, whether the acquisition adjustment is approved will drive the economics of
2 the deal, and the decision to close the deal or not would then depend on the approval of the
3 acquisition adjustment.

4
5 **Q. Were the recommendations of this Staff Report adopted in Global's subsequent rate**
6 **case?**

7 A. No.

8
9 **Q. Is there a regulatory principle that supports allowing acquisition adjustments?**

10 A. Yes. Professor Bonbright, in his classic treatise, *Principles of Public Utility Rates*, stated
11 in Chapter XII, Original Construction Cost Versus Subsequent Acquisition Cost, that "if
12 the transfer... was an essential, or at least a desirable, part of a program of integration,
13 justified in the public interest for the purpose of securing operating efficiencies... a claim
14 by the present company that its purchase of the acquired properties was, in effect, a
15 devotion of capital to the public service, cannot be dismissed as without merit." ¶ 6

16
17 And furthermore, Professor Bonbright wrote in Chapter XIII, The Depreciation or
18 Amortization of Acquisition-Adjustment Costs, that assuming the utilities commission
19 found the acquisition was in the public interest (as earlier outlined) then the cost above
20 book should be amortized – but "an arbitrary rate, such as characterizes accounting
21 practice with respect to some intangibles, may be chosen." ¶ 3

22
23 **Q. Is Willow Valley taking a position on the EWAZ's acquisition adjustment**
24 **mechanism?**

25 A. While we are not taking a position on the specifics of EWAZ's proposed mechanism, I
26 think EWAZ's proposal should be seriously considered. My point is that doing nothing
27 will get us nothing. My good friend, David Tenney, the Director of RUCO, likes to quote

1 the maxim of college wrestling's greatest coach, Dan Grable, who said "If nothing
2 changes, nothing changes."

3
4 In the past 16 years, nothing has changed with regard to consolidating the Arizona water
5 industry – meanwhile, Pennsylvania continues its consolidation approach and has gone
6 from over 500 water companies to under 150. ICFA's were a phenomenal tool for allow
7 developers to pay for water utility consolidation, and the RUCO Responsible Water white
8 paper had numerous recommendations—neither was implemented and nothing changed.
9 But if we try new things we will learn new things—and if we don't try new things, as Mr.
10 Tenney likes to say "nothing changes."

11
12 There current fragmented structure of the water utility industry is the result of the policies
13 and practices of the Commission. Policy change must happen if a change is desired.
14 There are plenty of policy options; what has been lacking is actual action on those options.
15
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Attachment Walker - 1

**In the Matter of the Application of
SourceGas Distribution LLC
for Approval of a General Rate Increase**

**Docket No. NG-_____
Volume 3 of 4**

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF NEBRASKA

In the Matter of the Application of
SourceGas Distribution LLC for Approval
of a General Rate Increase.

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Docket No. NG _____

PRE-FILED DIRECT TESTIMONY OF

ALAN R. LOVINGER

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1 **I. EDUCATIONAL BACKGROUND AND PROFESSIONAL QUALIFICATIONS**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Alan R. Lovinger and my business address is 1155 15th Street, NW,
4 Suite 400, Washington, DC 20005.

5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am a Vice President with the firm of Brown, Williams, Moorhead & Quinn, Inc.

7 **Q. WHAT SERVICES DOES THE FIRM OFFER?**

8 A. The firm provides technical and policy assistance to various segments of the natural
9 gas, electric and oil industries on business and regulatory matters.

10 **Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT**
11 **EXPERIENCE.**

12 A. I graduated from Bryant University in 1965 with a B.S. Degree in Business
13 Management. That same year, I enrolled in an MBA program at Texas Tech
14 University majoring in Accounting. Prior to joining Brown, Williams, Moorhead &
15 Quinn, I was employed by the Federal Energy Regulatory Commission as a Senior
16 Accountant, for twenty-five years, from 1966 to 1969 and from 1976 to 1998. My
17 work at the Commission primarily related to cost of service matters with an
18 emphasis on income tax issues. I provided expert testimony on accounting and
19 accounting-related policy matters before the Commission. I also presented expert
20 testimony on cost of service matters and provided accounting and tax advice and
21 assistance on various projects, including construction of facilities to serve new or
22 expanded markets. I also represented the Commission in dealings with the Internal
23 Revenue Service on income tax issues relating to tax normalization that arose in
24 various rate proceedings and assisted the Commission on rulemakings for such cost
25 of service matters as tax normalization, cash working capital, and post-retirement
26 Benefits Other than Pensions.

1 Between 1970 and 1976, I was employed as an Internal Revenue Agent and
2 in that capacity I was involved in the auditing of individuals, partnerships and
3 publicly held corporations.

4 **II. PURPOSE OF TESTIMONY**

5 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

6 A. I will address the IRS tax normalization rule and its impact on the appropriate level
7 of Accumulated Deferred Income Taxes ("ADIT") used in the computation of rate
8 base in this proceeding and I will explain why the computation is consistent with
9 regulatory accounting regulations and requirements of the Internal Revenue Service
10 Tax Normalization Rules.

11 **Q. PLEASE EXPLAIN THE ISSUE RELATED TO THE COMPOSITION OF ADIT**
12 **USED FOR RATEMAKING.**

13 A. The Internal Revenue Regulation §167 provides a deduction for a reasonable
14 allowance for the exhaustion, wear and tear of using property in a trade or business.
15 Section 167 cross-references Section 168 for determining depreciation deductions
16 for most property placed in service after 1980. Section 168 was added in 1981 to
17 provide for more liberal methods and lives than previously allowed under Section
18 168. Section 168 was amended in 1986 and provides for the Modified Accelerated
19 Cost Recovery System ("MACRS"). MACRS generally applies to tangible property
20 placed in service after 1986. Both SourceGas Distribution and the previous owner of
21 SourceGas Distribution's assets used MACRS in the computation of depreciation
22 expense in their respective income tax returns. For ratemaking and financial
23 statement purposes, utilities use a straight-line method for determining depreciation
24 expense. Consequently, the different methods of calculating annual depreciation
25 expense for tax and financial purposes on utility depreciable assets produce what is
26 commonly termed book/tax timing differences. The current ratemaking method as

1 permitted by the NPSC is to recognize book/tax timing differences prescribed by
2 Section 168 is tax normalization.

3 **III. BACKGROUND OF THE INTERNAL REVENUE SERVICE NORMALIZATION**
4 **REQUIREMENT**

5 **Q. CAN YOU PLEASE EXPLAIN THE BACKGROUND OF THE INTERNAL**
6 **REVENUE SERVICE NORMALIZATION REQUIREMENT?**

7 A. Yes. To understand the IRS Tax Normalization requirement, it is helpful to begin
8 with the background of the rule. Congress enacted accelerated depreciation in 1954
9 to encourage industrial expansion. Accelerated depreciation defers taxes that a
10 company would otherwise pay. Congress perceived this deferral of taxes as an
11 interest free loan, which can be used by companies for capital improvements and
12 expansion that would stimulate the post World War II economy.

13 **Q. HOW DID REGULATORY BODIES TREAT ACCELERATED DEPRECIATION**
14 **AFTER CONGRESS ENACTED IT IN 1954?**

15 A. Initially, regulators had two choices. They could choose either a Flow-through
16 method of regulation or a Normalization method.

17 **Q. COULD YOU EXPLAIN THESE TWO METHODS OF HANDLING ACCELERATED**
18 **DEPRECIATION?**

19 A. Yes. Let me first explain the Flow-Through method. In this method, the regulators
20 allow the regulated utility to collect in its cost of service for tax expense only what it
21 actually pays. In the early years of an asset, the lower income taxes that result from
22 accelerated depreciation "flow-through" to the utility's customers. In essence, the
23 regulator gives the customers the government "loan" to use. Under this method,
24 later customers will have to pay the higher tax bill because while accelerated
25 depreciation results in lower taxes initially, ultimately those lower taxes are paid to

1 the IRS in the later years of the assets' useful life when less depreciation can be
2 claimed for tax purposes.

3 **Q. CAN YOU EXPLAIN THE OTHER METHOD KNOWN AS "NORMALIZATION"?**

4 **A.** Yes. Under the Normalization Method, the utility customers pay the same amount
5 for tax expense in the cost of service that they would have paid had the taxes paid
6 by the utility been calculated using straight line depreciation. Under this method, the
7 utility collects from its customers more in taxes than it pays the IRS during the early
8 years of the assets' useful life. The income tax effect of the book/tax timing
9 difference is recorded in a deferred tax account. The deferred tax account for
10 utilities subject to the Federal Energy Regulatory Commission's Uniform System of
11 Accounts is Account No. 282, Accumulated Deferred Income Taxes – Other
12 Property. The "deferred" taxes are removed from Account No. 282 in the later years
13 of the asset life when the utility pays higher taxes to the IRS than it collects from its
14 customers in rates. The point in time when the utility begins to drawn down on the
15 ADIT associated with a particular asset is referred to as the "cross-over" point.

16 **Q. SO UNDER THE NORMALIZATION METHOD, IS IT CORRECT THAT THE**
17 **UTILITY KEEPS THE IRS "LOAN"?**

18 **A.** Not entirely. Under the Normalization Method, the utility does not keep the full
19 advantage of the IRS "loan" because the amount of ADIT is deducted from rate
20 base; however, the utility has the unrestricted use of the funds until the loan is paid
21 back. The ratepayers share in the benefit of normalization because this cost free
22 capital, ADIT, is used as a reduction to rate base; consequently, ratepayers do not
23 pay a return on the funds that the utility received as a loan from the IRS. The
24 utility's deduction of ADIT from rate base in later years decreases, after the "cross-
25 over" period, as prior period deferred taxes are paid to the government.

1 Q. WHICH METHOD DID REGULATORS USE -- THE FLOW-THROUGH METHOD
2 OR THE NORMALIZATION METHOD?

3 A. For many years after Congress introduced accelerated depreciation, regulatory
4 agencies did not hold consistent positions regarding rate treatment. Regulators
5 handled accelerated depreciation differently, depending upon how they viewed
6 accelerated depreciation and whether the advantages of this "loan" should accrue to
7 the customers or to the utility and depending upon the regulator's view of the need
8 to match the income tax allowance in the cost of service to the incurrence of the
9 utility's tax liability.

10 Q. DID THAT CHANGE?

11 A. Yes. Ultimately, Congress became concerned that "flow-through" decisions by
12 regulators, which passed on the tax deferral to the customers, resulted in a
13 "doubling of the Government's loss of revenue, from the use of accelerated methods
14 of depreciation for tax purposes. This is because the flow-through of the tax
15 reduction reduces the rates charged to customers, which in turn reduces the utility's
16 taxable income and therefore reduces its income tax. This second level of tax
17 reduction is passed on to the utility's customers, with the same effect." H.R. Rep 94-
18 413, 91st Cong., 1ST Sess. 1969, 1969 U.S.C.A.N. 1645, 1969 WL 5895 at 121.

19 Q. SO WHAT DID CONGRESS DO ABOUT THIS CONCERN RELATED TO FLOW-
20 THROUGH TREATMENT BY REGULATORS?

21 A. In the Tax Reform Act of 1969, Congress enacted a rule in Section 441 of the Tax
22 Reform Act, which added § 167 (l) to the Internal Revenue Code. This rule basically
23 provided that if a taxpayer is taking accelerated depreciation and is not normalizing
24 its deferred taxes, then it must use the straight line method when determining its
25 depreciation expense for federal income tax purposes. Congress considered no
26 longer permitting utilities to use accelerated depreciation. However, Congress

1 believed that removing accelerated depreciation from regulated utilities would place
2 the utilities at an unfair competitive disadvantage both in terms of the sale of their
3 products and services and their attractiveness to equity investors. Id. at 122. The
4 legislative history reflects that Congress intended to remove regulatory agencies'
5 ability to require flow-through of deferred taxes. As stated in the legislative history,
6 regulatory agencies "will be permitted to in effect force the taxpayer to straight line
7 depreciation by not permitting normalization. The regulatory agency will not, in such
8 cases, be permitted to require flow through of deferred taxes." Id. In other words, as
9 a practical matter, Congress took away a regulatory agency's ability to order flow-
10 through of deferred taxes by taking away the utilities' ability to use accelerated
11 depreciation in the event the regulator ordered the flow-through method of
12 accounting.

13 **Q. DID CONGRESS BELIEVE THAT ACCELERATED DEPRECIATION WAS GOOD**
14 **FOR BOTH THE UTILITY AND ITS CUSTOMERS?**

15 **A.** Yes. The 1969 tax change was at issue in a case that went to the United States
16 Supreme Court. This case involved Texas Gas Transmission Corp.'s request for
17 permission from the Federal Power Commission to use accelerated depreciation
18 with normalization with respect to its post-1969 expansion property. Federal Power
19 Comm'n v. Memphis Light, Gas & Water Div., 41 U.S. 464, 93 S.Ct. 1723 (1973).
20 The Supreme Court opinion discussed the fact that accelerated depreciation is good
21 for both the customers and the company:

22 "[Accelerated depreciation with] normalization in computing the tax
23 allowance for rate purposes . . . offers more hope for stability of
24 rates for its customers and more assurance that the company can
25 earn its fair rate of return without future rate increases. Further
26 benefits of normalization are that it will improve the company's
27 before tax coverage of interest, thereby enhancing the quality of its
28 securities, and that it will help alleviate present day cash
29 shortages." Id. at 465.

1 Q. ARE YOU AWARE OF ANY ADDITIONAL SIGNIFICANT EVENT RELATED TO
2 TAX NORMALIZATION?

3 A. There are two other significant events: the Economic Recovery Tax Act of 1981 and
4 the IRS Normalization Regulations.

5 Q. COULD YOU EXPLAIN HOW THE 1981 ACT RELATES TO ACCELERATED
6 DEPRECIATION?

7 A. Yes. The 1981 Act requires the normalization approach by regulators as a condition
8 for accelerated depreciation by public utilities of post-1981 properties. S.Rep. 97-
9 144, at 56 (1981), as reprinted in 1981 U.S.C.C.A.N. 105, 161. The purpose of the
10 1981 amendment was to provide an investment stimulus that Congress viewed as
11 essential for economic expansion. Congress viewed accelerated depreciation as a
12 way of increasing the profitability of investment and encouraging businesses to
13 replace old equipment and structures with modern assets that reflect better
14 technology. Congress was trying to restructure the depreciation deduction . . . as a
15 way of stimulating capital formation, increasing productivity and improving the
16 nation's competitiveness in international trade. Id. at 1981 U.S.C.C.A.N. 105, 152.

17 Congress was also trying to make the rules simpler. Id. The legislative
18 history of the 1981 Act makes it clear that Congress viewed "deferred taxes" as an
19 interest-free loan to the utility. Id. at 149. The utility is able to use this money in lieu
20 of funds that otherwise would have to be obtained by borrowing or raising equity
21 capital. Id. Thus, Congress did not want to allow accelerated depreciation unless the
22 regulatory body used the normalization method to account for it. This is why the act
23 states that the amount of capital that is deducted from rate base must not exceed
24 the amount of the deferred taxes recorded in compliance with tax normalization.

1 **IV. IRS NORMALIZATION RULE**

2 **Q. WITH THAT BACKGROUND, COULD YOU EXPLAIN THE IRS NORMALIZATION**
3 **RULE?**

4 A. Yes. The tax normalization method of accounting, Regulations Section 1.167(l)1(h),
5 requires a utility that uses accelerated depreciation to use the straight-line method
6 of depreciation (a straight-line method that matches annual book depreciation
7 expense, i. e. service life and rate) in computing its tax expense and its depreciation
8 expense for purposes for establishing cost of service for ratemaking purposes. The
9 Regulations further require the utility to calculate the annual tax effect of book/tax
10 timing differences and record the increase or decrease on its books in a deferred tax
11 account. The Regulations further require that the ADIT balance be used as a
12 reduction to the utility's rate base.

13 However, if the regulator requires the utility to continue to carry an ADIT
14 balance on its books when that ADIT balance has been eliminated, the utility would
15 be prevented from using accelerated depreciation in current and future years. Thus,
16 the utility would not get the benefit of any tax savings from accelerated depreciation
17 and the cost free capital associated with the book/timing difference.

18 **Q. PLEASE PROVIDE MORE DETAILS AS TO THE HARM A UTILITY WOULD**
19 **INCUR IF IRS DETERMINED THAT A VIOLATION OF THE TAX**
20 **NORMALIZATION RULES WERE TO OCCUR IN THIS RATE CASE.**

21 A. As stated above, Congress originally enacted the normalization rules to ensure that
22 the capital formation benefits of accelerated depreciation be retained by the utility
23 and for the ratepayer to benefit from reduced rates through the adjustment to rate
24 base. The intent of the tax normalization is to prevent regulators from passing the
25 benefits of accelerated depreciation to ratepayers by reducing the income tax
26 allowance. The normalization rules dictate that accelerated depreciation deductions

1 determined under Section 168 do not apply to any utility property if the taxpayer
2 does not use normalization method of accounting. Tax normalization rules also
3 require that ADIT reserve be reduced to reflect asset retirement. Thus, when a utility
4 that owns public utility property that it depreciates under an accelerated method for
5 tax purposes sells public utility assets, it is required by the normalization rules to
6 eliminate all associated deferred taxes recorded in Account No. 282 to reflect the
7 retirement of those assets.

8 **Q. DOES THAT COMPLETE YOUR EXPLANATION OF THE BACKGROUND OF**
9 **THE IRS TAX NORMALIZATION RULES?**

10 **A.** Yes.

11 **V. APPLICATION OF THE TAX NORMALIZATION RULE IN THIS CASE**

12 **Q. PLEASE DESCRIBE THE TRANSACTION THAT RESULTED IN SOURCEGAS**
13 **DISTRIBUTION ACQUIRING UTILITY ASSETS FROM KINDER MORGAN.**

14 **A.** SourceGas Holdings LLC is a Delaware limited liability company that was formed in
15 2006. SourceGas Holdings is fifty percent owned by an affiliate of the General
16 Electric Capital Corporation, and fifty percent collectively owned by Alinda
17 Investments LLC, a private equity firm, and an affiliated Alinda equity fund.
18 SourceGas LLC is a wholly-owned subsidiary of SourceGas Holdings. Immediately
19 prior to the closing of the sale of the natural gas utility business by Kinder Morgan in
20 March 2007, Kinder Morgan, Inc. contributed the natural gas utility assets that
21 constituted its natural gas distribution business to SourceGas Distribution LLC, a
22 Delaware limited liability company. When the sale was closed, SourceGas LLC
23 became the owner of 100% of the limited liability interests of SourceGas Distribution
24 LLC.

25 **Q. WHAT WERE THE TAX CONSEQUENCES TO THE SELLER WITH THE ASSET**
26 **SALE AS DESCRIBED ABOVE?**

1 A. The transaction was treated as an asset sale for federal income tax purposes.
2 Accordingly, the sale was recognized as a taxable transaction of the LDC assets
3 resulting in taxable gain or loss to KM. Under the Code, gain is determined by the
4 amount realized reduced by the seller's adjusted tax basis in the asset sold and is
5 reportable by the seller under Code Section 1001.

6 KM has further obligations under tax normalization rules. When a utility that
7 owns public utility property that it depreciates under an accelerated method for tax
8 purposes sells public utility assets, it is required by the normalization rules to reduce
9 its deferred tax reserve to reflect the retirement of those assets. Accordingly, the
10 ADIT balance associated with the sold assets is removed from the seller's
11 regulatory books of account. This removal reflects the fact that utility's interest free
12 debt is now payable to IRS to recognize the seller's gain or loss on the sale of utility
13 assets, pursuant to Code Section 1001. The buyer takes a new basis in the
14 acquired utility assets that reflects the buyer's asset purchase price (referred to as a
15 step-up cost basis to reflect the fact that the new buyer has a higher basis than the
16 previous owner).

17 **Q. WHAT IS THE SIGNIFICANCE OF THE STEP-UP IN THE TAX BASIS OF THE**
18 **UTILITY PROPERTY FOR SOURCEGAS DISTRIBUTION?**

19 A. As a result of the acquisition by SourceGas, the ADIT balance on KM's regulatory
20 books was reduced to zero in recognition of KM's taxable gain on its sale of utility
21 assets. Consequently, the purchased assets were recorded on SourceGas
22 Distribution's books with a zero balance in the deferred tax account, Account No.
23 282. The transaction was treated as an asset purchase. Consequently, SourceGas
24 Distribution's tax basis of the acquired assets increased, from what was KM's tax
25 basis for those assets just prior to the acquisition, to the acquired cost for those
26 assets, which for regulatory purposes was determined to be equal to the remaining

1 net book basis of the depreciable plant on the date of the purchase. Because the
2 new tax basis established for SourceGas Distribution's depreciable assets
3 exceeded the prior remaining tax basis on the books of KM, on a going forward
4 basis, SourceGas Distribution will recognize higher tax depreciation expense that
5 will generate more ADIT over the assets' depreciable lives than KM would have had
6 if the sale did not take place.

7 **Q. IS THERE ANOTHER REASON WHY SOURCEGAS DISTRIBUTION WILL**
8 **RECOGNIZE ANNUAL INCREASES TO ACCUMULATED DEFERRED TAXES**
9 **ABOVE WHAT KM WOULD HAVE GENERATED ON AN ANNUAL BASIS?**

10 **A.** Yes. Besides the fact that SourceGas Distribution has a larger tax depreciable
11 basis than that available to KM, SourceGas Distribution will depreciate the balance
12 at an accelerated rate due to SourceGas Distribution's election for the use of
13 MACRS. MACRS establishes a depreciable life for most of the acquired assets of
14 15 years. MACRS depreciation rates in the early years use accelerated rates that
15 decrease in each succeeding year. Thus, SourceGas Distribution will recognize
16 significantly more tax depreciation and accordingly higher yearly deferred tax
17 accruals than would have been recorded by KM had the acquisition not taken place.

18 **Q. YOU TESTIFIED ABOVE THAT ON THE DATE OF SALE THE BUYER WOULD**
19 **HAVE A DEFERRED TAX BALANCE OF ZERO FOR TAX PURPOSES. WILL**
20 **SOURCEGAS DISTRIBUTION ALSO HAVE A DEFERRED TAX BALANCE OF**
21 **ZERO?**

22 **A.** Yes. Both SourceGas Distribution's financial records and its regulatory books will
23 reflect a beginning zero balance for deferred taxes.

24 **Q. DO SOURCEGAS DISTRIBUTION'S REGULATORY BOOKS ALSO BEGIN WITH**
25 **A ZERO BALANCE IN THE RESERVE FOR DEPRECIATION?**

1 A. No. The depreciable basis and the reserve for depreciation for rate purposes and
2 accordingly for SourceGas Distribution's regulatory books remain consistent with the
3 depreciable basis and reserve reflected on the books of KM prior to the acquisition.
4 These balances are maintained to be consistent with the "original cost" regulatory
5 concept.

6 Q. **WHAT ARE THE RATE AND TAX IMPLICATIONS IF A REGULATOR DOES NOT**
7 **RECOGNIZE THE FULL IMPLEMENTATION OF TAX NORMALIZATION RULES?**

8 A. The normalization rules dictate the regulatory treatment of income tax expense and
9 accumulated deferred income tax reserves or ADIT. The IRC further provides that
10 accelerated depreciation determined under IRC Section 168 does not apply to any
11 public utility property if the taxpayer does not use a tax normalization method of
12 accounting. Thus, a utility cannot use accelerated methods of depreciation for utility
13 property if that taxpayer does not comply with the tax normalization rules.

14 Simply stated, the tax normalization rules require a utility to maintain an
15 accumulated deferred income tax (ADIT) account for the tax effect of the difference
16 between regulatory book depreciation and accelerated depreciation. The ADIT
17 recorded on the utility's regulatory books must be maintained in accordance with tax
18 normalization rules. The Internal Revenue Code ("IRC") further requires that the
19 ADIT balance be maintained in accordance with IRC Section 168 and that such
20 balance be used in the determination of rate base. Thus, if regulators were to
21 require a flow-through of tax benefits or use the prior owner's ADIT balance in the
22 computation of rate base, this act would cause a violation of IRS regulations and the
23 utility would be prevented from computing accelerated depreciation pursuant to IRC
24 Section 168. As a result, ratepayers would pay higher rates in the future due to the
25 increase in rate base caused by the loss of accelerated tax depreciation. Further,

1 the utility would need to raise additional capital since it could not count on interest
2 free loans generated from the use of accelerated tax depreciation.

3 **Q. PLEASE IDENTIFY THE SPECIFIC IRC REFERENCE THAT PRESCRIBES THE**
4 **METHOD USED TO DETERMINE TAX DEPRECIATION IF IRS DETERMINES**
5 **THAT A VIOLATION OF TAX NORMALIZATION HAS OCCURRED?**

6 A. The specific reference is Internal Revenue Code Section 168(i)(9)(c) provides:
7 Public Utility Property Which Does Not Meet Normalization Rules – In the case of
8 any public utility property to which this section does not apply by reason of
9 subsection (f)(2), the allowance for depreciation under section 167 (a) shall be the
10 amount computed using the method and periods referred to in subparagraph (A)(i).

11 Subparagraph (A)(i) of Section 168(i)(9) provides:

12 the taxpayer must, in computing its tax expense for
13 purposes of establishing its cost of service for ratemaking
14 purposes and reflecting operating results in its regulated
15 books of account, use a method of depreciation with respect
16 to such property that is no shorter than the method and
17 period used to compute its depreciation expense for such
18 purposes;
19

20 Thus, the Internal Revenue Code restricts tax depreciation to the utility's
21 regulatory depreciation method when there is a normalization violation.

22 **Q. ARE YOU AWARE OF ANY IRS RULING IN WHICH A REGULATED UTILITY**
23 **INVOLVED IN A DEEMED SALE OF ASSETS WOULD HAVE INCURRED A**
24 **NORMALIZATION VIOLATION?**

25 A. Yes, I am. On August 4, 1994, the IRS, in Private Letter Ruling 9447009, ruled that
26 there would be a normalization violation if, subsequent to the date of the acquisition
27 and deemed sale of assets of a natural gas transmission company, the natural gas
28 company's rate base were reduced for the balance in the reserve for the ADIT
29 attributable to accelerated depreciation on public utility property before the

1 acquisition date. Its parent sold the gas company to the buyer pursuant to a Section
2 338(h)(10) transaction. Such transaction, although structured as a stock sale, was
3 treated as an asset sale by the selling and buying corporations for tax purposes.
4 The IRS ruled that because of the deemed sale of the seller's assets, the seller's
5 ADIT balance ceased to exist and had to be removed from the seller's regulated
6 books of account and could not be flowed through to customers. Further, the IRS
7 ruled that a normalization violation would occur if the seller's ADIT balance that
8 existed before the acquisition were used to reduce the buyer's rate base.

9 **Q. HOW DOES THE FEDERAL ENERGY REGULATORY COMMISSION'S**
10 **UNIFORM SYSTEM OF ACCOUNTS ADDRESS THE ACQUISITION OF ASSETS**
11 **WITH RESPECT TO ADIT?**

12 A. The tax effect of the book/tax timing differences for plant investment is recorded in
13 FERC Account No. 282. With respect to the Regulations, Part 201, Account No.
14 282, Part D, the FERC specifically restricts the use of Account No. 282 to the
15 purpose for which the account was established. Deferred income tax recorded in
16 Account No. 282 must represent the tax liability due because of the recognition of
17 book/tax timing differences. Further, the regulations specifically restrict transferring
18 any balance to retained earnings or making any other use thereof, except as
19 provided by instructions to Account No. 282. The instructions state that:

20 "Upon the disposition by sale, exchange, transfer, abandonment or
21 premature retirement of plant on which there is a related balance
22 herein, this account shall be charged with an amount equal to the
23 related income tax expense, if any, arising from such disposition . . ."

24 Thus, the FERC rules recognize that upon an asset sale (or a deemed asset
25 sale for income tax purposes as is the case with SourceGas Distribution), the
26 seller's ADIT balance is extinguished since any deferred taxes are due and payable
27 by the seller at the time of sale.

1 Q. HAVE YOU DISCUSSED THE PROCEDURES USED BY SOURCEGAS
2 DISTRIBUTION IN THE COMPUTATION OF ADIT RECORDED IN ACCOUNT NO.
3 282 TO BE USED IN THE COMPUTATION OF RATE BASE IN THIS
4 PROCEEDING AND, IF SO, WHAT IS YOUR CONCLUSION?

5 A. Yes, I have discussed those procedures and it is my opinion that SourceGas
6 Distribution has put in place on its books all of the necessary steps needed to
7 properly determine an ADIT balance that will be fully compliant with the
8 requirements of tax normalization and the Uniform System of Accounts.

9 Q. IN YOUR OPINION, HAS SOURCEGAS DISTRIBUTION TAKEN THE
10 APPROPRIATE STEPS NEEDED TO AVOID A NORMALIZATION VIOLATION?

11 A. Yes.

12 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

13 A. Yes.

Attachment Walker - 2

APR 11 1950

Principles of Public Utility Rates

Second Edition

by
JAMES C. BONBRIGHT
ALBERT L. DANIELSEN
DAVID R. KAMERSCHEN

with assistance of
JOHN B. LEGLER

Public Utilities Reports, Inc.
Arlington, Virginia

\$1 billion excess acquisition price (or any part thereof) has been held to be a proper component of the rate base, as reflecting capital devoted to the public service, it should then receive corresponding treatment in the manner in which it should be depreciated or (in other words) amortized. But how rapidly it should be amortized is a difficult question to answer with confidence unless the excess purchase price can be intelligently distributed to the various plant accounts, tangible and intangible. If this is not feasible, an arbitrary rate, such as characterizes accounting practice with respect to some intangibles, may be chosen. But in any event, the amortization should be treated as an operating charge for ratemaking purposes — a conclusion which militates against a speed of amortization seriously burdensome to present consumers.

Current practice is to treat assets purchased at a price in excess of net book value as an excess cost. A utility would like to recover the excess cost and earn a return through acquisition adjustments, but the most common practice is to amortize the cost as an expense over a period of years so that there is a return of investment, but no return on the excess cost of the investment. A utility may be allowed to include the unamortized part of the excess cost in the rate base, thereby permitting a return on the unrecorded excess cost. However, most commissions are skeptical of transfers between utilities at excess costs, so rate base adjustments are generally not made unless the utility can demonstrate actual, distinct, and substantial benefits to all affected ratepayers (see Nixon, 1985). A utility that acquires a new service territory with the newly purchased assets may be held to a higher standard in proving benefits to ratepayers. But the point is that the burden of proof is on the company.

In general, acquisition adjustments are now amortized "below-the-line" over a period not to exceed the life of the property to which they relate unless the utility can demonstrate that ratepayers benefited by the acquisition. If such a showing can be made, which, according to Faudree (1987), to this point has been relatively rare at FERC, a utility may include the amortization expense "above-the-line" and include the expense in its cost of service. The unamortized balance, where above-the-line amortization is approved, would normally be allowed as a component of rate base.

NORMALIZATION VERSUS FLOW-THROUGH OF ACCELERATED DEPRECIATION TAX BENEFITS

In the public utility field, one of the more important controversies

about depreciation has concerned the accounting and ratemaking effects of the provisions of the tax codes permitting business corporations, in calculating taxable income, to use diminishing-charge procedures of depreciation accounting: specifically, a declining-balance method and a sum-of-the-years-digits method. These liberalized tax-accounting allowances were historically supported in the Congressional committee hearings partly on the ground that they would stimulate business investments, and partly on the ground that they come closer than straight-line depreciation accounting to a reflection of the rates at which most fixed assets actually depreciate in value from the dates of acquisition to the dates of retirement.

But many public utility companies have chosen to stress the first point and to ignore the second. That is to say, they have fairly generally decided to take advantage of the diminishing-charge deductions for tax purposes, while resting content with straight-line depreciation procedures for their financial statements and, presumably, for ratemaking purposes. As a result, and since they have been in an era of heavy plant expansion rather than in an era of stable equilibrium between acquisitions and retirements, their Federal income taxes are reduced by the accelerated rate of tax depreciation, whereas their annual allowances for depreciation as reported to the public service commissions remain unaffected.

By way of making accounting adjustments for this discrepancy between their income reports for tax purposes and their income reports for regulatory purposes, many companies have sought leave to include, as operating charges, the higher income taxes to which they would be subject were they to report taxable income on a straight-line basis. The excess in these "normalized" taxes over current tax liabilities is to be carried to a special deferred-tax account, against which to charge any later, offsetting enhancements in income taxes. This accounting procedure was sanctioned very early on by the Federal Power Commission, Federal Communications Commission, and many state commissions. Today the state and federal commissions are divided fairly evenly on normalization versus flow-through; the FERC, FCC, and 23 state commissions require flow-through (Shepherd, 1985, p. 365).

But the really important issue is concerned with the ratemaking aspects of this accounting problem, and here each of three major alternatives (along with some rather question-begging compromises) has derived support from some commissions. The first position, is that a public utility company which elects to pay income taxes on a diminishing-charge basis of depreciation accounting may receive no allowance for any taxes beyond those for which it is actually liable in a given year (i.e., tax savings flow-through to ratepayers). The second

position is that a ratemaking allowance shall be made for normalized taxes as an operating deduction but that no offsetting deduction shall be made in the measurement of the rate base, since the account for deferred taxes is deemed to constitute a restricted surplus and not a reserve representing amortized capital costs. The third position is that (both for ratemaking and for accounting purposes) normalized taxes shall be accepted as operating deductions but that any excess in such tax allowances over actual taxes shall be credited to a special reserve account, the amount of this reserve being deducted from cost used in arriving at the rate base just as is the ordinary depreciation reserve. Almost all utilities now follow the third method.

The second alternative at one time was popular with the public utility industries since, from their point of view, it had the charm of imposing upon the consumers the obligation to pay deferred-tax allowances which, instead of being transmitted forthwith to the United States Treasury, were treated as capital investments entitled indefinitely to the enjoyment of a fair rate of return for the benefit of the corporate stockholders. In this respect it had the same charm as that once possessed by the practice under which some public utilities would demand straight-line allowances for accruing depreciation while insisting on the deduction of nothing but a minimum "observed depreciation" in the measurement of the rate base. Support for this position of the industry was once forthcoming from the Federal Power Commission and from a few state commissions. However, this was changed in FERC Order No. 530B.

We never have seen a plausible defense for a claim to the enjoyment of a profit on funds not contributed by the corporate investors. The defense usually offered was that plant expansion financed by these funds enhances management costs and increases the risk factor. But management costs are covered in the allowances for operating expenses, not in the rate of return. And the risk factor (which may even be reduced, not increased, if the company is permitted to accrue a so-called deferred-tax reserve, as it will under Alternative Number 3) is properly taken into account in the allowance of a fair rate of return on capital contributed by the investors. Hence, there is no need to concede to stockholders a return on capital contributed, in effect, either by the taxpayers or by the ratepayers.

The Case for Flow-through

The main argument for a commission's refusal to make any deferred-tax allowance in a rate case — for the flow-through principle — is that, as long as the tax law remains unchanged and as long as

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additions to depreciable corporate assets exceed retirements, the tax deferment will be continuous and hence will amount, in effect, to a permanent tax saving. With qualifications, this contention is correct in that a reduction in current taxes below what these taxes would be under straight-line accounting will not later be offset by an increase in these taxes beyond what they would be under straight-line.

But under flow-through, the major benefit of the tax reduction would go to the earlier ratepayers, in the years in which the tax payments have been reduced, instead of being apportioned among ratepayers more nearly in proportion to their relative responsibility for payments for services resulting in eventual tax liabilities. As an argument against the accrual of a tax-deferral reserve, the permanent-deferral theory is suspiciously similar to the discredited "plant immortality" theory of depreciation, mentioned early in this chapter, which was once adduced by the utility industry as an argument against the deductibility of accumulated depreciation from cost new in the determination of the rate base.

The Case for Normalization

As we see it, the only reasonable controversy as to the choice among the three aforementioned alternatives is that between the view that, for ratemaking purposes, companies should receive no allowances for taxes other than for actual current taxes, and the view that, if they practice liberalized-depreciation accounting for purposes of income taxation, they should receive an annual allowance for deferred taxes combined with a deduction of the resulting deferred-tax reserve from what would otherwise be the rate base. Here we are convinced that the weight of the argument lies with the latter position, and this for three reasons: first, that this position is in harmony with the modern tendency to regard straight-line depreciation as erring on the side of a retarded allowance for cost recoupment rather than excessive allowance as was once often thought to be the case; secondly, that the very practice of taking rapid depreciation for tax purposes tends to reduce more rapidly the actual values of the depreciating assets — namely, their tax-saving values; and thirdly, that unless utility companies are permitted to set up reserves against deferred taxes, thereby protecting themselves against the possible repeal of the diminish-charge provision of the present tax law, they are likely to exercise what has been held to be their option to ignore these provisions in favor of the orthodox straight-line tax accounting — an option adverse to the long-run interests of their customers. Substantially all utility companies follow this practice and it is required by FERC. That is, FERC rules currently

require that deferred taxes be deducted from the rate base and many state commissions follow this practice. The utilities prefer normalization as it increases their profitability and preserves a stimulus or incentive to investment.

The FERC and many of the state commissions now require that full interperiod income tax allocation be followed for accounting and ratemaking purposes. In all of the jurisdictions that we are aware of in which income tax normalization is followed, the accumulated deferred income tax balances are used as a rate base deduction (or included in the capital structure for rate of return calculation purposes at zero cost). Further, even in those jurisdictions where some flow-through of taxes is required for ratemaking purposes, the Internal Revenue Code requires that most property-related timing differences be normalized in order for the utility to be eligible for liberalized depreciation.

Summary of Final Rule Requiring Tax Normalization

FERC Docket No. RM80-42, R-424, R-446. In a ruling that became effective July 6, 1981, the FERC amended its regulations to require tax normalization for the tax effects of certain timing differences of transactions involving electric utilities and interstate gas pipelines. The final rule also codified the existing Commission rulemaking practice of adjusting rate base for accumulated deferred income taxes. Finally, the final rule required adjustments in the deferred taxes for utilities' and pipelines' cost of service for two types of circumstances:

- (1) when inadequate or excessive provision for deferred taxes had been made for the tax effects of timing different transactions within the scope of the rulemaking that had previously been given flow-through treatment.
- (2) when inadequate or excessive provision for deferred taxes had been made as a result of changes in tax rates.

Although the limited extent of FERC jurisdiction restricts required range of applicability, the companies often argue for their application to properties devoted to both jurisdictional and nonjurisdictional service. Not only does this simplify their accounting procedures, but it also helps to avoid a "no one's land" where incurred costs can be charged to neither federal nor state jurisdictions.

Attachment Walker - 3

The Regulation of
Public Utilities
Theory and Practice

CHARLES F. PHILLIPS, JR.

Robert G. Brown
Professor of Economics
Washington and Lee University

1985
PUBLIC UTILITIES REPORTS, INC.
Arlington, Virginia

on to them, thereby tending to lull the public into a frame of mind which allows government expenditures to be increased without strong opposition.¹⁴⁰

*Interperiod Income Tax Allocation*¹⁴¹

Although public utilities are subject to many types of taxes, federal income taxation presents the most complex and controversial issues. At the outset, it must be recognized that there is commonly a difference between income and expenses for accounting (book) purposes and for income tax purposes. As explained by the Accounting Principles Board of the American Institute of Certified Public Accountants:

The principal problems in accounting for income taxes arise from the fact that some transactions affect the determination of net income for financial accounting purposes in one reporting period and the computation of taxable income and income taxes payable in a different reporting period. The amount of income taxes determined to be payable for a period does not, therefore, necessarily represent the appropriate income tax expense applicable to transactions recognized for financial accounting purposes in that period. A major problem is, therefore, the measurement of the tax effects of such transactions and the extent to which the tax effects should be included in income tax expense in the same periods in which the transactions affect pretax accounting income.¹⁴²

Where there are book/tax timing differences,¹⁴³ income taxes must be apportioned among accounting periods. That process is known as *interperiod income tax allocation*. Three major areas that require allocation follow: accelerated depreciation, investment (job development) tax credit, and consolidated tax returns.

Accelerated Depreciation: The "Phantom Tax" Issue. Under the Revenue Act of 1954, business firms are permitted to adopt accelerated

¹⁴⁰*Re Intermountain Gas Co.*, 35 PUR 3d 342 (Idaho, 1960). See also *Re Bell Teleph. Co. of Nevada*, 31 PUR 3d 392 (Nev., 1959); *Re Florida Water Service*, 32 PUR 3d 320 (Fla., 1960); and *Re Missouri Utilities Co.*, 43 PUR 3d 423 (Mo., 1962). In Illinois, and in a few other jurisdictions, even franchise taxes are treated in this manner. See, e.g., *Village of Maywood v. Illinois Commerce Comm.*, 178 N.E. 2d 345 (1962).

¹⁴¹For a more comprehensive discussion, see Hahne and Aliff, *op. cit.*, chap. 17.

¹⁴²Accounting Principles Board, Opinion No. 11, "Accounting for Income Taxes" (1967).

¹⁴³Differences may be either timing (differences between book income and tax income that will reverse in subsequent periods, i.e., deferred income taxes) or permanent (differences between book income and tax income that will not reverse in some future period, i.e., interest on governmental obligations, which is exempt for tax purposes but is recognized for book purposes). Timing differences, in turn, may refer to items that relate to revenues (gains or losses from sale of utility property), expenses (fuel expenses), or property (due to depreciation methods). For examples of major timing differences, see Hahne and Aliff, *op. cit.*, pp. 17-74—17-77.

depreciation in calculating taxable income, thereby charging higher depreciation expenses in the early years of the service life of assets than would be allowed under straight line depreciation and lower rates in later years. The effect is to produce lower tax payments with respect to the early years which are offset by increased tax payments in the remaining years. The act posed a problem for the regulatory commissions: should they include, for rate-making purposes, as operating costs the higher income taxes to which utilities would be subject were they to report taxable income on a straight line basis ("normalization" method) or should they include only the taxes actually paid ("flow through" method) by the utilities? If the normalization method is adopted, the utilities, in effect, are granted during the early years of the property's life an interest-free loan of the difference between taxes paid and taxes due under the straight line method.¹⁴⁴ The implication is that the act results in a tax deferral rather than a permanent tax saving. The difference could be used for modernization and expansion or for other financial needs. If the flow through principle is adopted, the tax deferrals are denied to the utilities and the reduced tax expense can be used to raise reported earnings or to reduce consumer rates.

The normalization and flow through methods are compared in Table 7-3. Assume that a utility invests \$10,000 in new equipment, that its estimated useful service life is ten years, that it has no removal cost, and that the estimated salvage value is \$1,075. Using the straight line method, \$892.50 would be charged to depreciation expense annually. Using accelerated depreciation (assuming the double-declining balance method), the annual depreciation charge would start at \$2,000 and decline to \$268 over the ten-year period. In either case, the utility would receive a tax saving during the first four years. However, the effect on net income would not be identical: normalization accounting would result in no effect on net income, while under flow through accounting net income would be increased in the first four years and decreased in the last six years of the equipment's service life.

The Controversy. Income tax normalization has been the subject of considerable controversy. It is charged by many consumer groups that normalization results in ratepayers paying "phantom taxes."

... The argument relies on the assumption that because the utility's business will probably continue to grow, the deferred tax account will also continue to grow indefinitely. The phantom tax advocates contend that, as the deferred taxes grow at a rapid pace, there will always be more revenues collected to cover the deferred tax expense than deferred taxes paid out.

¹⁴⁴For accounting purposes, the tax effect of the depreciation difference is placed in a reserve for deferred income taxes.

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They further allege that such a method gives rise to a "permanent tax savings" rather than a "tax deferral" that would eventually be paid out when the timing differences reach a reversal point (i.e., the book expense is higher than the tax expense).¹⁴⁵

The phantom tax argument is fallacious. As explained by Hahne and Aliff:

The error of the phantom tax argument may be seen by analogy with the growth of a long-term debt account. As any issue of long-term debt reaches maturity, it must be repaid. At the same time, new plant additions may require that capital be raised through additional long-term borrowing to finance the additions. That new issues may exceed repayment of maturing debt over any period so as to result in net growth of long-term debt in no way means that the debt is not being repaid nor that, in the future, when the new issue matures, it will not have to be repaid.¹⁴⁶

For many years, the utilities themselves debated the wisdom of adopting accelerated depreciation, even when permitted by the commissions. The Bell System, to illustrate, did not take advantage of accelerated depreciation until 1970. Its decision to use straight line depreciation for both accounting and tax purposes was based on three considerations:

1. Congress might suspend, modify, or repeal the accelerated tax depreciation provisions at some future date, thereby resulting in a sudden decline in per share earnings and a possible drop in the market price of a utility's stock.
2. A multistate utility, subject to several jurisdictions, might find some commissions permitting normalization and others flow through; a situ-

¹⁴⁵Hahne and Aliff, *op. cit.*, p. 17-26. Compare, e.g., *Re Alabama-Tennessee Nat. Gas Co.*, 52 PUR 3d 118 (FPC, 1964), *aff'd*, 359 F.2d 318 (1966), *cert. denied*, 385 U.S. 847 (1966), with *Colorado Municipal League v. Pub. Utilities Comm.*, 597 P.2d 586 (Colo., 1979). See also D. Kiefer, *Accelerated Depreciation and the Investment Tax Credit in the Public Utility Industry: A Background Analysis* (Columbus, Ohio: National Regulatory Research Institute, 1979).

¹⁴⁶Hahne and Aliff, *op. cit.*, pp. 17-26—17-27. The Revenue Act of 1978 (Pub. Law 95-600) lowered the federal corporate income tax rate from 48 to 46 percent. How should the commissions recognize the fact that deferred taxes had been accumulated at the 48 percent rate for many years? Some commissions held that the deferred tax reserves should be reversed at the original rate of 48 percent. [See, e.g., *Re Southwestern Bell Teleph. Co.*, 36 PUR 4th 283 (Mo., 1980).] Others took the position that the deferred tax reserves were excessive, and that the surplus deferred taxes should be amortized over one to ten years. [See e.g., *Re Chesapeake & Potomac Teleph. Co. of West Virginia*, 40 PUR 4th 279 (W. Va., 1980).] The latter method, which results in a reversal of the tax deferred over a period shorter than the lives of assets, may not meet the statutory normalization requirements, thereby resulting in the disallowance of accelerated tax depreciation. [See, e.g., *Kansas Power & Light Co. v. Kansas State Corp. Comm.*, 620 P.2d 329 (1980).]

TABLE 7-3
Illustration of Effect of Accelerated Depreciation, for Tax Purposes, on Net Income*

A. NORMALIZATION ACCOUNTING						
Year	Straight Line Depreciation (a)	Accelerated Depreciation (b)	Effect On Taxable Income (c = b - a)	Effect On Taxes Payable (d = c x .46)	Credit (or Charge) to Deferred Taxes (e = -d)	Effect On Net Income (f = d + e)
1	\$ 892.50	\$ 2,000.00	\$ -1,107.50	\$ -509.45	\$ +509.45	0
2	892.50	1,600.00	707.50	-325.45	+325.45	0
3	892.50	1,280.00	387.50	-178.25	+178.25	0
4	892.50	1,024.00	131.50	-60.49	+60.49	0
5	892.50	819.00	73.50	+33.81	-33.81	0
6	892.50	655.00	237.50	+109.25	-109.25	0
7	892.50	524.00	368.50	+169.51	-169.51	0
8	892.50	419.00	473.50	+217.81	-217.81	0
9	892.50	336.00	556.50	+255.99	-255.99	0
10	892.50	268.00	624.50	+287.27	-287.27	0
			0	0	0	0
	\$ 8,925.00	\$ 8,925.00				
Salvage value	\$ 1,075.00	\$ 1,075.00				
Total	\$10,000.00	\$10,000.00				

B. FLOW THROUGH ACCOUNTING

Year	Straight Line Depreciation (a)	Accelerated Depreciation (b)	Effect on Taxable Income (c=b-a)	Effect on Taxes Payable (d=c x .46)	Effect on Net Income (e=-d)
1	\$ 892.50	\$ 2,000.00	\$ -1,107.50	\$ -509.45	\$ +509.45
2	892.50	1,600.00	- 707.50	-325.45	+325.45
3	892.50	1,280.00	- 387.50	-178.25	+178.25
4	892.50	1,024.00	- 131.50	- 60.49	+ 60.49
5	892.50	819.00	+ 73.50	+ 33.81	- 33.81
6	892.50	655.00	+ 237.50	+109.25	-109.25
7	892.50	524.00	+ 368.50	+169.51	-169.51
8	892.50	419.00	+ 473.50	+217.81	-217.81
9	892.50	336.00	+ 556.50	+255.99	-255.99
10	892.50	268.00	+ 624.50	+287.27	-287.27
			0	0	0
Salvage value	\$ 8,925.00	\$ 8,925.00			
	\$ 1,075.00	\$ 1,075.00			
Total	\$10,000.00	\$10,000.00			

*The following assumptions underlie the computations: original investment, \$10,000; no removal cost; salvage value, \$1,075.00; estimated service life, ten years; accelerated depreciation, 20 percent declining balance method; 46 percent federal income tax rate.

ation which would result in confusion on the part of investors and expensive record keeping on the part of a utility.

3. Flow through, which was required by many of the commissions, impairs the financial integrity of a utility by: (a) failing to recognize current costs, since a tax cost is understated during the early life of the property; (b) increasing investor risk, since future depreciation deductions might not be available to offset the past costs which were not recognized under this method, while economic conditions or regulatory commissions might not allow future rate increases; and (c) endangering the ability of a utility to raise funds because of large amounts of unprovided-for costs overhanging the business.¹⁴⁷

Commission Treatment. Prior to 1969, the regulatory commissions were split over the proper method to employ. The Federal Power Commission, which at first permitted normalization,¹⁴⁸ adopted the flow through method early in 1964.¹⁴⁹ The Federal Communications Commission, until 1971, required the flow through method. As of July 1, 1967, 20 state commissions permitted various forms of the normalization method for rate-making purposes, 23 (including the District of Columbia commission) had either ordered or favored the flow through method, and two permitted either method.¹⁵⁰

¹⁴⁷See Gerald J. Glassman, "Objections to Taking Liberalized Depreciation," 77 *Public Utilities Fortnightly* 29 (March 31, 1966); Herman Green, "Proper Regulatory Treatment of Liberalized Depreciation," 78 *ibid.* 31 (July 7, 1966); and C. N. Ostergreen, "Accelerated Depreciation and Rate Making Once More," 81 *ibid.* 48 (January 18, 1968). But see Donald C. Cook, "The Flow Through of Tax Benefits," 77 *ibid.* 170 (June 9, 1966), for an argument that accelerated depreciation should be adopted even if flow through is required.

It has been estimated that if the Bell System had elected to use accelerated depreciation in 1954, its income tax liabilities would have been reduced by a total of \$1.6 billion by the end of 1965, resulting in cumulative reductions in charges to consumers of about \$3 billion. Testimony of A. L. Stott, FCC Docket No. 16258 (Bell Exhibit 38, October 17, 1966) Attachment C; and Testimony of William J. Powell, FCC Docket No. 16258 (FCC Staff Exhibit No. 29), p. 10.

¹⁴⁸*Re Panhandle Eastern Pipe Line Co.*, 3 PUR 3d 396 (FPC, 1954), *aff'd sub nom. City of Detroit v. Federal Power Comm.*, 230 F.2d 810 (D.C. Cir. 1955); and *Re El Paso Nat. Gas Co.*, 29 PUR 3d 469 (FPC, 1959). See Note, "Liberalized Depreciation: About-Face by the FPC," 50 *Virginia Law Review* 298 (1964).

¹⁴⁹*Re Alabama-Tennessee Nat. Gas Co.*, *op. cit.* Further, in 1966, the FPC held that the increased federal income tax payments resulting from the decision of a natural gas pipeline company to discontinue the use of accelerated depreciation were not a reasonable and prudent business expense. *Re Midwestern Gas Transmission Co.*, 64 PUR 3d 433, 444 (FPC, 1966).

¹⁵⁰Federal Power Commission, *Federal and State Commission Jurisdiction and Regulation. Electric, Gas, and Telephone Utilities, 1967* (Washington, D.C.: U.S. Government Printing Office, 1968), p. 38; Eugene F. Brigham, "Public Utility Depreciation Practices and Policies," 19 *National Tax Journal* 144 (1966); and H. Bierman, Jr., "Accelerated Depreciation and Rate Regulation," 44 *Accounting Review* 65 (1969). For typical decisions, compare *Re Gulf Power Co.*, 10 PUR 3d 273 (Fla., 1956) (normalization permitted) with *City of Pittsburgh v. Pennsylvania Pub. Utility Comm.*, 17 PUR 3d 249 (1957) (flow through required).

Then, in the Tax Reform Act of 1969, public utilities were required to use either straight line depreciation or accelerated depreciation with normalization for tax purposes. Most commissions, therefore, beginning in 1970, permitted normalization of deferred taxes for both book and rate-making purposes (although some continued to use flow through on pre-1970 property).¹⁵¹ In such instances, a utility is not permitted to earn a return on the deferred taxes; that is, they are either deducted from a utility's rate base or included in a utility's capitalization at a zero cost rate.¹⁵² Further, it should be noted again that normalization is required for a utility to elect the accelerated cost recovery system under the Economic Recovery Tax Act of 1981.

The Investment (Job Development) Tax Credit. The Revenue Act of 1962 (Pub. Law 87-834) provided, as an incentive to investment, that a business firm could deduct from its federal income tax liability a specified percentage based on the amount of new investment in most plant and equipment which it put into service during a taxable year. The Code has been suspended and modified over time.¹⁵³ Under the latest laws (Tax Reduction Act of 1975, Pub. Law 94-12, as modified by the Economic Recovery Tax Act of 1981, Pub. Law 97-34), all businesses are eligible for a credit graduated up to 10 percent on property placed in

¹⁵¹The most publicized exception was in California, where the commission's decision to permit normalization in 1970 (Decision No. 77984, November 24, 1970) was overturned by the California Supreme Court (*San Francisco v. California Pub. Utility Comm.*, 91 PUR 3d 209 (1972)). If the 1969 act did prohibit utilities from using accelerated depreciation and the investment tax credit with flow through, the court's position would have resulted in Pacific Telephone and General Telephone of California having tax liabilities in excess of \$2.2 billion for delinquent taxes, penalties, and interest. In fact, in 1978, the Internal Revenue Service sent Pacific Telephone a deficiency notice. Congress resolved the dispute by adding an amendment to federal gasoline tax legislation which made more specific "the rules under which public utilities lose the investment credit and accelerated depreciation when these tax benefits are flowed through too rapidly to consumers" and which resulted in compromise payments of \$321 million by Pacific Telephone and \$97.7 million by General Telephone. 49 *Telecommunications Reports* 1, 26 (January 10, 1983). On the dispute, see A. Dahl, "The California Remand Case: Controversy over Normalization," 104 *Public Utilities Fortnightly* 13 (December 20, 1979).

A few other state commissions continue to use the flow through method [see, e.g., *Gulf States Utilities Co. v. Louisiana Pub. Service Comm.*, 364 So. 2d 1266 (1978)] or the flow through method for computing a utility's state income tax expense [see, e.g., *Continental Teleph. Co. of Maine v. Maine Pub. Utilities Comm.*, 397 A. 2d 1001 (1979)]. See also "Recent Decisions on Accelerated Depreciation and Normalization," 105 *Public Utilities Fortnightly* 49 (May 8, 1980).

¹⁵²See, e.g., Eugene F. Brigham and James L. Pappas, *Liberalized Depreciation and the Cost of Capital* (East Lansing: MSU Public Utilities Studies, 1970).

¹⁵³Under the 1962 act, nonregulated firms, as well as natural gas producers and pipeline companies and transportation firms received a percentage that was graduated up to 7 percent, depending on the estimated life of the new property; other public utilities received a percentage graduated up to 3 percent. To qualify for the full credit, the property had to have a life of eight years or more. The act further provided that the tax base of the eligible property was to be lowered by an amount equal to the tax credit. The Revenue Act of 1964 (Pub. Law 88-272), among other things, prohibited the federal

GLOBAL WATER RESOURCES INC.
COMPARISON OF RATE IMPACTS (USING GLOBAL COST OF DEBT VS EPCOR COST OF DEBT)

	Global Water	EPCOR	Variance
Estimated Rate Base	\$1,964,397	\$1,964,397	\$0
ACC Recognized Debt	57.8%	57.8%	0.0%
ACC Recognized Equity	42.2%	42.2%	0.0%
Cost of Debt	6.1%	4.1%	2.0%
Return on Equity (ROE)	9.5%	9.5%	0.0%
WACC	7.530%	6.380%	1.2%
Regulatory Tax Imputation (GRCF)	1.6651	1.6651	0
Calculated Return on Rate Base	\$246,300	\$208,685	\$37,616
<u>ADIT Impacts</u>			
ADIT Amount		\$260,224	
Return on Rate Base Impact of ADIT		\$27,644	

EXHIBIT

Global

4/14/2017
ADMITTED



0000030680

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
ChairmanJIM IRVIN
CommissionerWILLIAM A. MUNDELL
Commissioner

Arizona Corporation Commission

DOCKETED

NOV 03 2000

DOCKETED BY

RT

IN THE MATTER OF THE ARIZONA
CORPORATION COMMISSION'S OWN
MOTION TO ESTABLISH THE COMMISSION
WATER TASK FORCE

DOCKET NO. W-00000C-98-0153

DECISION NO. 62993ORDEROpen Meeting
October 24 and 25, 2000
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On April 24, 1998, in Decision No. 60829, the Arizona Corporation Commission (Commission) established the Commission Water Task Force (Task Force). The Task Force consists of representatives of regulatory agencies, the water providers, and water consumers. On September 22, 1998, the Task Force held its first meeting. The Task Force meetings were all noticed Open Meetings.

2. On October 28, 1999, the Task Force completed its Report for the Commission (Report). The Report contains recommendations to the Commission on several issues facing Arizona's water industry. On many issues, the Task Force achieved consensus. On other issues, the Report contains different recommendations from the various Task Force members.

3. On January 5, 2000, the Task Force Report was docketed and distributed to every Arizona water company regulated by the Commission. A deadline of March 15, 2000, was set for comments on the Report to be filed. Only two water companies and the Central Arizona Project (CAP) submitted comments. Arizona Water Company generally supports the Staff's proposals, but does express some reservations. Lakewood Water Company, a small water company in Amado, indicates that it is currently struggling with the financial requirements to fund necessary capital improvements. The capital costs to make improvements would double the rates for the company's customers, many of whom are low-income. The company expresses interest in the possibility of

Decision No. 62993

1 consolidation with other water utilities. The CAP generally supports Staff's proposals, but it de
2 express some reservations.

3 4. The Task Force was divided into three subcommittees: the Regulatory Reform
4 Subcommittee, the Conservation Subcommittee, and the Water Supply Subcommittee. The Regulatory
5 Reform Subcommittee achieved consensus on five goals:

- 6 • Reduce the number of small, non-viable water systems through new rules and procedures.
- 7 • Strengthen the financial capacity of the water utility industry.
- 8 • Provide greater emphasis on simplifying, shortening, and reducing the cost of the
- 9 ratemaking process.
- 10 • Improve consumer education.
- 11 • Increase interagency coordination.
- 12
- 13

14 5. The Conservation Subcommittee focused on developing policies the Commission coul
15 use to encourage water conservation. The Water Supply Subcommittee focused on issues relevant to
16 renewable and surface water supply, such as the Central Arizona Project.

17 **Regulatory Reform Subcommittee**

18 6. On Pages 3 through 25 of the Report, the Regulatory Reform Subcommittee's
19 recommendations and discussions are summarized.

20 7. On Pages 4 through 7 of the Report, Staff's proposal on placing more stringent
21 requirements on approval of CC&Ns for new water companies is discussed.

22 8. Commission Staff recommended the following Commission policy changes concerning
23 the establishment of new water companies:

- 24 a. The application for a new CC&N must show that an existing water company cannot
- 25 or will not serve the area being applied for. This showing must be made by submitting
- 26 service rejection letters from all the "A" size water companies in the state (there are 3)
- 27 and at least five of the "B" size companies (there are 20). The five B size companies
- 28 contacted should include the B size companies that are geographically closest to th
applicant. The application must also be accompanied by service rejection letters

1 from all the existing water companies within five miles of the area being requested. In
2 addition, the rejection letters must be accompanied by the corresponding request for
3 service that was made to each of the existing water companies by the applicant.

- 4 b. The rates should be set such that the company should at least break even no later than
5 its third year of operation. The calculations would be based on the company's
6 reasonable estimates of customer growth. The company should also be required to
7 come in for a rate case three years after serving its first permanent customer.
- 8 c. Because Staff believes that it is not in the public interest, no new CC&N would be
9 issued to any company that was affiliated with any other company or person that was
10 not in total or substantial compliance with Commission and ADEQ requirements. This
11 restriction should apply to CC&N extensions and transfers as well.
- 12 d. Staff recommends establishing a set of standard service charges for new CC&Ns.
- 13 e. Staff will work with the ADWR to establish tiered rate structures for new CC&Ns.

14 9. Staff recommends that the Commission endorse Staff's recommendations. Further,
15 Staff requests that the Commission order Staff to develop (through meetings with members of the
16 industry, RUCO, and other interested parties) a detailed statement of policy on water CC&Ns by
17 June 30, 2001. The detailed statement of policy should conform to the general principals of Staff's
18 recommendation contained in the Report and the above discussion. Staff members who are
19 responsible for processing new water CC&N requests should be responsible for conducting these;
20 meetings and developing the detailed statement of policy.

21 10. On Pages 8 through 11 of the Report, several proposals for providing incentives for
22 consolidation in the water industry are discussed. Staff recommends that an acquisition adjustment
23 or a rate of return premium (but not both) be allowed under certain conditions. These conditions are:

- 24 • The acquisition is in the public interest;
- 25 • The acquisition will not negatively affect the viability of the acquirer;
- 26 • The acquired system's customers will receive improved service in a reasonable timeframe;
- 27 • The purchase price is fair and reasonable (even though that price may be more than the
28 original cost less depreciation book value) and conducted through an arms' length
negotiation;

- The recovery period for the acquisition adjustment should be for a specific minimum time (e.g., twenty years); and
- The acquired company is a class D or E.

11. Staff does not recommend allowing for acquisition adjustments unless all of the above conditions are met. Staff believes that the burden should be on the company to prove that an acquisition adjustment or a rate of return premium is in the public interest. The public interest determination should account for the capital investments needed for the customers to receive improved service and the costs savings the company is likely to realize through economies of scale. Other methods of encouraging consolidation include allowing for rate of return premiums and deferral accounting orders. Staff recommends that the Commission endorse Staff's recommendation. Further, Staff requests that the Commission order Staff to develop, through meetings with members of the industry, RUCO, and other interested parties, a detailed statement of policy on acquisition adjustments and rate of return premiums by June 30, 2001. The detailed statement of policy should conform to the general principals of Staff's recommendation contained above and in the Report. Staff members who are responsible for recommending approval or denial of acquisition adjustment requests should be responsible for conducting these meetings and developing the detailed statement of policy.

12. Other incentives for consolidation could be provided by the State Legislature. Tax breaks or credits could be provided to companies that choose to acquire small and/or financially non-viable water companies. The Staff requests the Commission adopt recommendations to the Legislature regarding incentives for consolidation and direct the Commission's Legislative Liaison to initiate efforts to encourage the Legislature to adopt these incentives.

13. The establishment of a fund similar to the Universal Service Fund used for telecommunications firms, is another option for improving the financial capacity of small water companies. A fund that all water companies pay into and that financially strapped companies could draw out of for infrastructure investments could be established. For fairness purposes municipal water

1 companies would need to be included as contributors/beneficiaries of the fund. This would require
2 legislation as well as changes to the Commission rules. Staff proposes this fund as an approach the
3 Commission may want to consider in the future.

4 14. Issues involving property taxes are discussed on Pages 12 and 13 of the Report. The
5 Staff requests the Commission adopt recommendations to the Legislature regarding alternative taxation
6 mechanisms for private water companies and direct the Commission's Legislative Liaison to initiate
7 efforts to encourage the Legislature to adopt these tax alternatives. Staff also recommends that the
8 Accounting and Rates (A&R) section of the Utilities Division sponsor, for any interested party, a
9 seminar on the ratemaking implications of property taxes, focusing on the problems the industry
10 outlines in the Report.

11 15. On Pages 14 and 15 of the Report, the Future Test Year issue is discussed. Staff
12 believes that there is no need to change the present method used by the Commission. At present, the
13 Commission employs an historical test year but does allow for pro forma additions for known and
14 measurable costs. It is Staff's opinion that this is a very good combination of both historical and future
15 test years. Presently, this is done on a case-by-case basis. Staff believes that this method could be
16 improved, therefore, Staff recommends that the Commission order Staff to develop a policy with
17 specific requirements for expense changes, revenue changes, and plant additions that occur after the
18 test year. Such items would include, but are not limited to:

- 19
20 a. Method of matching new expenses with new revenues.
21 b. Revenue neutral plant, i.e., plant to serve existing, not future, customers.
22 c. Revenue neutral plant will be installed within a specific timeframe, preferably one year.
23 d. Revenue neutral plant is necessary to provide proper and adequate service to existing
24 customers.

25 16. On Pages 15 and 16 of the Report, Staff's recommended Generic Hook-up Fee policy
26 is outlined. Both the industry and RUCO support Staff's recommendation in principal. Staff believes
27 that implementing this recommendation will require a rulemaking proceeding. Staff requests that the
28 ...

1 Commission order a rule making proceeding be opened to implement a Generic Hook-up Fee polir
2 along the lines of Staff's proposal.

3 17. On Pages 16 through 19 of the Report, proposals for plant replacement fund
4 mechanisms are discussed. Staff recommends that the Commission adopt a policy similar to the
5 Pennsylvania Public Utilities Commission's Distribution Service Investment Charge (DSIC). Staff
6 requests that the Commission order a rule making proceeding be opened to implement rules for a DSIC
7 or similar program in Arizona.

8 18. On Pages 19 and 20 of the Report, problems associated with past high depreciation
9 rates are discussed. The industry offered proposals on how to rectify these problems; however, Staff
10 and RUCO found those approaches to be inappropriate. Staff believes that its proposed Rate of Return
11 policy (discussed below) will solve the problems associated with past excessive depreciation rates. All
12 parties agreed that the Commission should no longer approve excessive depreciation rates for small
13 water companies.

14 19. On Pages 20 and 21 of the Report the pass-through mechanism approved by the
15 legislature in SB 1252 (now A.R.S. § 40-370) is discussed. The industry representatives on the Task
16 Force felt that the Commission's policy on A.R.S. § 40-370 needed to be clarified because, at the time
17 the Report was written, only one company had applied for authority to adjust rates under the provisions
18 of this mechanism. Since then the Commission has approved two such applications (they both have
19 been appealed). The two approved applications were for Arizona Water Company's Monitoring
20 Assistance Program (Decision No. 62141) and Rio Verde Utilities, Inc.'s CAP cost increase (Decision
21 No. 62037). Those two decisions indicate that the Commission's policy on A.R.S. § 40-370
22 applications is to support appropriate pass-throughs, which should mitigate the industries concerns.

23 20. On Pages 21 and 22 of the Report, Staff's proposed Rate of Return policy is outlined.
24 Staff believes that implementing this policy will solve the problems associated with high depreciation
25 rates and lead to other improvements. This policy would make filing rate cases much less burdensome
26 for small water companies. Staff's proposed policy allows companies that are filing rate applications
27 to choose between 1) a generic rate of return (for C, D, and E companies only); 2) setting rates based
28 on an operating margin basis (i.e., no rate of return consideration); or 3) an individual rate of return

1 (i.e., traditional rate making). In addition to the recommendations in the Report, Staff is
2 recommending that the choice of the generic rate of return be limited to C, D, and E companies. Also,
3 Staff recommends that the generic rate of return should be a minimum rate of return; thus, points can
4 be added to it to account for special expenses such as WIFA loan payments. Staff requests that the
5 Commission order a rule making proceeding be opened to implement Staff's proposed Rate of Return
6 policy. Staff is aware that the recent Court of Appeals Opinion may impact the Commission's ability
7 to implement Staff's proposed rate of return policy. Staff believes that the issues raised by the Court
8 of Appeals Opinion are best dealt with during the rulemaking proceedings.

9 21. On Pages 22 and 23 of the Report, the electronic filing of annual Reports, rate cases,
10 and other filings with the Commission is discussed. Staff, the industry, and RUCO all agreed that
11 allowing for electronic filing would be beneficial. Staff has already initiated the first steps of this
12 process by making the Short Rate Case Form available on the Commission's web site. Staff is
13 committed to making all of its forms available electronically. In order to institute full electronic filing,
14 the Hearing Division will need to be involved. Staff is committed to working with the Hearing
15 Division to develop a process that will allow for full electronic filing.

16 22. During the Task Force's discussions of electronic filing, the industry also expressed
17 concern about the volume and extent of the Commission's filing requirements. Staff acknowledges
18 that certain filing requirements may be out-dated. Staff is currently reviewing all forms and filing
19 requirements. However, such a review is a major undertaking and may take some time to complete.

20 23. On Page 23 of the Report, Staff's Main Extension Agreement (MXA) proposal is
21 outlined. Staff's proposal is to have standard MXA provisions included in each water companies
22 tariffs, instead of the current process of approving MXAs on an individual case basis. Both the
23 industry and RUCO supported Staff on this issue. Staff requests that the Commission order a rule
24 making proceeding be opened to implement Staff's proposed MXA policy.

25 24. On Pages 23 and 24 of the Report, several suggestions concerning consumer education
26 are discussed. Staff is currently working on educational programs for all industries the Commission
27 regulates. Implementing any educational program may require additional funds from the Legislature.
28 Staff is also evaluating the expansion of its well-regarded Small Water Assistance Team (SWAT)

1 program (which deals with educating water company owners/operators) to include education for water
2 consumers.

3 25. On Pages 24 and 25 of the Report, Staff's Phased Rate Increase policy is discussed.
4 Staff believes that in certain limited circumstances it is appropriate to phase rate increases in over
5 time. Staff will develop well-defined guidelines for when and how phased rate increases are
6 appropriate.

7 26. On Page 25 of the Report, Staff's recommendation on rates tied to conditions is
8 discussed. Staff recommends that all rate increases be conditioned on the company providing
9 acceptable quality service, water quality, and other relevant conditions. Staff has already implemented
10 this policy informally by including specific conditions in recent Recommended Orders. Staff will
11 develop a standard set of conditions that could apply to all water companies. One impediment to this
12 policy being successful is the Commission's lack of enforcement resources. Currently, the Utilities
13 division has *one* compliance officer to handle *all of the utilities* the Commission regulates.

14 **Conservation Subcommittee**

15 27. On Pages 26 through 29 of the Report, the Conservation Subcommittee's
16 recommendations and discussions are described. On Pages 26 through 28, a perceived problem with
17 the Commission's conservation policy is discussed. The industry and consumer members of the Task
18 Force as well as the ADWR representatives believed that the Commission would not allow companies
19 to include the costs of conservation programs in rates unless the conservation program was mandated
20 by the ADWR. If this were true, it would discourage companies from engaging in conservation
21 programs. However, Staff does not believe that this is true. No member of the Task Force could site
22 any examples of instances where Staff has recommended denial of conservation program costs or
23 where the Commission approved an order that included the denial of conservation programs and their
24 reasonable costs. Staff supports and encourages conservation. Staff believes that recovery of any
25 reasonable costs for conservation programs should be allowed.

26 28. On Pages 28 and 29, Staff's proposal to institute three tiered rates is discussed. Tiered
27 rates are the Commission's only direct means of encouraging conservation. Both the industry and
28 RUCO opposed Staff's proposal. The industry claimed that it is sure to result in companies

1 underearning, while RUCO claimed the policy is sure to result in companies overearning. Staff
2 believes that as with any rate design there is a possibility of either over or underearning. However,
3 with rates designed as proposed by Staff in the Task Force's Report there is almost no chance of
4 underearning while there is a good possibility of overearning. If properly designed though, the tiered
5 rates would result in the non-conserving customers paying extra for large uses of water and reward
6 those customers that used very little water. If customers conserved such that all were falling within
7 the middle tier, the company should earn its allowed rate of return. If the customers continued to use
8 water in the third tier, the water company would probably overearn. The use of the overearnings could
9 be restricted by the Commission in such a manner as to benefit the customers. Staff realizes that this
10 is a new and different way of looking at rate design combined with conservation, but Staff also realizes
11 that new ways have to be considered to save what many consider to be this State's most precious
12 resource. Staff recommends that the Commission order Staff to consider tiered rate designs for all
13 water company rate cases and that the tiers be designed to encourage conservation. Staff recognizes
14 that tiered rates may not be appropriate in all cases and that the decision to use or not use tiered rates
15 must be made on a case-by-case basis. However, the appropriateness of tiered rates should be
16 considered in every case. Further, Staff requests that the Commission order Staff to develop a detailed
17 statement of policy on tiered rates by June 30, 2001.

18 Water Supply

19 29. On Pages 30 through 33 of the Report, the Water Supply Subcommittee's
20 recommendations and discussions are summarized. The main focus of this subcommittee was the
21 recovery of Central Arizona Project (CAP) water allocation costs (CAP costs). All members of the
22 Subcommittee agreed that the Commission could somehow approve the recovery of CAP costs in a
23 proceeding outside of a rate case. However, the Commission's Legal division has concluded that
24 considering CAP costs outside of a rate case would run counter to the recent Court of Appeals opinion
25 on fair value. There was disagreement among the Subcommittee members about what the
26 Commission should require before it allows for CAP cost recovery. In the Report, Staff recommended
27 that the Commission allow for CAP cost recovery once the company has submitted a plan that
28 indicates how they will begin to actually use their CAP allocations within five years. Staff chose a

1 five-year time horizon because Staff wished to limit the extent to which current customers are charged
2 for CAP allocations which will only be used to serve future customers.

3 30. Since the Report was written, Staff has modified its position. Staff believes that the
4 Commission should be more flexible with the time horizon it allows for CAP water to go unused while
5 allowing cost recovery. Staff believes that the time requirement placed on companies applying for
6 CAP cost recovery should be decided on a case by case basis. Also, to ensure that current customers
7 do not pay an unfair amount relative to future customers, a portion of the CAP cost should be
8 recovered through some type of hook-up fee. The amount of the recovery that is recovered through
9 a hook-up fee should be determined by the company's total demand for water relative to its CAP
10 allocation. For example, if a company's total demand is 200,000 gallons per year and its CAP
11 allocation is 1,000,000 gallons per year, then the company should recover 20 percent of its CAP cost
12 from current customers and the remaining 80 percent from hook-up fees. The methodology used for
13 CAP cost recovery in the Vail Water Company Rate Case (Decision No. 62450) is an example of the
14 general policy that Staff advocates.

15 31. Staff requests that the Commission order Staff to develop, through meetings with
16 members of the industry, RUCO, and other interested parties, a detailed statement of policy on CAP
17 cost recovery by June 30, 2001. The detailed statement of policy should conform to the recovery
18 methodologies used in the Vail Rate Case, Decision No. 62450.

19 Conclusions

20 32. In conclusion, Staff recommends several changes in and clarifications of Commission
21 policy, several changes to the Commission's rules, and that the Commission pursue several Legislative
22 changes. These recommendations are summarized as follows:

23 Policy Changes

- 24
- 25 • CC&Ns (new, transfers, and extensions)
 - 26 • Acquisition Adjustments and Rate of Return Premiums
 - 27 • Seminar on ratemaking implications of property taxes
 - 28 • Electronic Filing and review of filing requirements
 - Phased Rate Increase
 - Rates tied to Conditions
 - Tiered Rate Structure

- CAP cost recovery
- Pro forma adjustments

Rulemaking

- Generic Hook Up Fee
- Rate of Return
- Main Extension Agreements
- Plant Replacement Fund

Legislative Changes

- Incentives for consolidation, e.g. tax breaks
- Replace property taxes with a percentage of revenue tax

33. Staff recommends that the Commission endorse the above policy and Legislative changes. Also, Staff recommends that the Commission open a rulemaking proceeding in order to implement the above changes to the Commission rules.

CONCLUSIONS OF LAW

1. The Commission as the regulatory body with the longest history and the primary responsibility over private water companies should take the lead in seeking a coordinated solution to the problems of small water companies.

2. The Commission arranged for the formation of the Task Force for meetings between representatives of regulatory agencies, the water providers, and water consumers in order to address these issues.

3. The Task Force has issued a report that summarizes the views of its members.

ORDER

THEREFORE, IT IS ORDERED that the Commission approve Staff's recommendations in the above Findings of Fact.

IT IS FURTHER ORDERED that this decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION
CHAIRMAN
COMMISSIONER
COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL,
Executive Secretary of the Arizona Corporation
Commission, have hereunto, set my hand and caused the
official seal of this Commission to be affixed at the Capitol,
in the City of Phoenix, this 3rd day of November 2000.


BRIAN C. McNEIL
Executive Secretary

DISSENT: _____

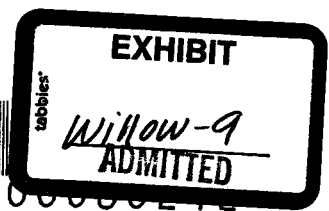
DRS:MJR:lh

Decision No. 62993

ORIGINAL



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MEMORANDUM

Arizona Corporation Commission

RECEIVED

TO: THE COMMISSION

DOCKETED

2001 JUN 29 P 12:08

FROM: Utilities Division

JUN 29 2001

AZ CORP COMMISSION
DOCUMENT CONTROL

DATE: June 29, 2001

DOCKETED BY	<i>sd</i>
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RE: WATER TASK FORCE OF THE ARIZONA CORPORATION COMMISSION
(DOCKET NO. W-00000C-98-0153)
(DECISION NO. 62993)

On November 3, 2000, the Commission issued Decision No. 62993. This decision approved Staff's recommendations regarding the Commission's Water Task Force. The Commission directed Staff to work with interested parties to develop policy statements, some of which are due by June 30, 2001. Staff has had a number of meetings with interested parties to discuss the issues and resolve parties' concerns on many occasions, as noted below. The reports addressing specific subjects reflect a consensus of the working groups. In only one working group did Staff disagree with a portion of the group's resolution of an issue, which is also discussed below. The reports address the following issues:

Finding of Fact No. 9 from Decision No. 62993 ordered Staff to develop a policy statement regarding Certificates of Convenience and Necessity for water systems. Attachment A to this memorandum is a proposal for this policy developed in a meeting with interested parties.

Finding of Fact No. 11 ordered Staff to develop a policy statement regarding acquisition adjustments and rate of return premiums for water systems. Attachment B to this memorandum is a proposal for this policy, which was developed based on several meetings with interested parties.

Finding of Fact No. 29 ordered Staff to develop a policy statement regarding tiered rates. Attachment C to this memorandum is Staff's proposal for this policy, which was developed after several meetings with interested parties.

Finding of Fact No. 31 ordered Staff to develop a policy statement regarding recovery of costs related to the Central Arizona Project. Attachment D is Staff's proposal for this policy, which was developed after several meetings with interested parties. Staff is in agreement with this proposal, except for the portion which deals with the definition of the term "use." The attached policy defines "use" as those methods considered as "use" by the Arizona Department of Water Resources (ADWR). The current regulations of ADWR allow a water company to be in compliance with its requirements as long as the water system uses its CAP water anywhere within the same Active Management Area (AMA) in which the water system is located. This approach is contrary to the position the Commission took in a recent Vail Water Company (Vail) rate case.

THE COMMISSION

June 29, 2001

Page 2

In Decision No. 62450, the Commission approved Vail's cost recovery of its CAP costs with specific mandates regarding Vail's long-term plans for the CAP water. At present Vail is using its CAP water in an "in lieu recharge project". Vail's CAP water is being used by a farm in Red Rock in lieu of the farm using groundwater. Because the farm in Red Rock is in the same AMA (Tucson AMA) as Vail, Vail gets credit for this use by the farm and therefore, is in compliance with ADWR requirements, even though the farm is approximately 60 miles from Vail. Staff believes that the water being recharged in Red Rock will never actually directly benefit the aquifer in Vail and therefore, never benefit the customers of Vail. This was the basis for the Staff recommendations that were adopted by the Commission in Decision No. 62450. The Commission ordered Vail to submit, within 10 years of the Decision, a plan to use its CAP water directly in its certificated area. Decision No. 62450 also ordered Vail to actually begin using its CAP water within its certificated area within 15 years of the Decision.

For these reasons, Staff recommends that the Commission slightly, but significantly, modify the definition of "use" contained in Attachment D by adding the condition that the water system would have to use its CAP water within its certificated area.

Staff recommends that these policy statements be discussed at an Open Meeting at the Commission's convenience.



Deborah R. Scott
Director
Utilities Division

DRS:SMO:

ORIGINATOR: Steven M. Olea

ATTACHMENT A
Proposed Policy
for
Water Certificates of Convenience and Necessity

The Commission has established a policy goal of ensuring Arizona's water consumers are served by viable utilities. In Decision No. 62993, the Commission required Staff to develop a policy statement on Certificates of Convenience and Necessity (CC&N) for water systems which conforms to the general principles of Staff's recommendation as contained in the Water Task Force Report of October 28, 1999.

The Arizona Constitution, Article 15, Section 3, provides in part: "The corporation commission shall have full power to, and shall... make reasonable rules, regulations and orders, by which such corporations shall be governed in the transaction of business within the state.... Provided further that...rules, regulations, orders and forms...may from time to time be amended or repealed by such commission. "

State law on CC&Ns requires, in part, that a public service corporation shall not begin construction of any plant or system without first obtaining a CC&N from the Commission. (See A.R.S. 40-281) In processing a CC&N the Commission is performing a judicial function, (See A.R.S. 40-282), Staff, as a party to the case, is charged with developing, and making a recommendation on the application to develop the record for the hearing on which the Commissioners base their final decision.

The Arizona Administrative Code R14-2-402, Certificate of Convenience and Necessity for water utilities, is used by Staff to guide the development of their recommendation on the application. The rule requires the Applicant to provide the following information:

- a. Proper name and address of the utility and its owners,
- b. Articles of Incorporation and Corporate Bylaws,
- c. Type of plant and facilities to be constructed,
- d. Complete description of facilities to be constructed, with preliminary engineering specifications to describe the principle systems and components to meet the needs of the health department, and final engineering drawings when they are available.
- e. The proposed rates,
- f. Estimated total cost of the facilities,
- g. Manner of capitalization, method of financing the utility,
- h. Financial condition of Applicant,
- i. Estimated annual operating revenue and expenses from the proposed construction,
- j. Estimated starting and completion dates of the proposed construction,
- k. Maps of the proposed service area,
- l. Appropriate city, county and/or state agency approvals,
- m. Estimated number of customers to be served for each of the first 5 years of operation, including documentation to support estimates.

Staff also requires the Applicant to provide: the request for service initiating the "necessity" of the request for a CC&N, appropriate approvals from the Arizona Department of Water Resources (ADWR) and the Arizona Department of Environmental Quality (ADEQ), and compliance status information from the ADEQ and ADWR.

In order to assist the Commission in its goal to eliminate the proliferation of non-viable water systems, it is recommended that in addition the above, the following should be required:

1. Unless the Applicant is an existing public water utility in Arizona or is an affiliate of an Arizona public water utility, an Applicant for a new CC&N (i.e., not an extension to an existing CC&N) must demonstrate that existing water utilities have refused to extend their territories to include the requested area. This demonstration shall be made by the Applicant providing all the following:
 - a. A copy of the Applicant's request for service from all Class A* water utilities in the State as well as the refusal to serve from all those Class A water utilities, and
 - b. A copy of the Applicant's request for service from all or at least five (5), whichever is less, of the Class B* water utilities serving within fifty (50) miles of the Applicant's requested area as well as the refusal to serve from all those Class B water utilities, and
 - c. A copy of the Applicant's request for service from all water utilities* serving within five (5) miles of the Applicant's requested area as well as the refusal to serve from all those water utilities.

* Any utility willing to serve must respond to the Applicant within thirty (30) days of the Applicant's request and must meet item #3 below.
2. If the Applicant has received an affirmative response to a request for service within thirty (30) days of its request from any of the above water utilities, but believes that such service would not be cost-effective nor in the public interest, the Applicant shall submit detailed information and cost data that clearly and convincingly demonstrates such an opinion and that the granting of a CC&N to the Applicant is in the public interest.
3. The Applicant must demonstrate that it and all its affiliates and associated management or operations personnel are in compliance with all applicable Commission, ADEQ, and ADWR requirements. In the event, the utility, any affiliate, or associated management or operations personnel are not in compliance with Commission, ADEQ or ADWR requirements, the Applicant must demonstrate that the non-compliance is related to the recent acquisition or affiliation with a deficient utility. With regard to ADE, the Applicant shall be considered in compliance if it, or any of its affiliates, does not have or has not had within the 12 months prior to the application, any major deficiencies with regard to physical facilities, operation and maintenance requirements, or monitoring requirements.

4. Initial rates for a new CC&N should be designed such that the utility would have the opportunity to break even (zero percent rate of return) at the end of its third year of operation. These rates should also provide the utility the opportunity to earn a reasonable rate of return by the end of its fifth year of operation. Rate levels and the rate of return would be based on the Applicants reasonable projections of customer growth and the rate base required to properly and adequately serve the customers.
5. For new CC&Ns that are not being served by an existing utility, the following charges shall be set as follows:
 - a. Establishment (normal) -- \$20.00
 - b. Establishment (after hours) -- \$35.00
 - c. Reconnection -- \$20.00
 - d. Meter Test (if correct) -- \$25.00
 - e. Deposit -- 2 times the monthly minimum plus 15,000 gallons
 - f. NSF Check -- \$25.00
 - g. Service Call (after hours) -- \$40.00
 - h. Meter Re-read -- \$35.00
 - i. Late Payment Fee -- 1.5 percent after 15 days

The above charges shall be reviewed annually by Staff and adjusted if necessary.

6. Once the CC&N is granted, the utility shall be required to file a rate case no later than 120 days after the fifth anniversary of serving its first customer.

ATTACHMENT B

Proposed Policy for Class D and E Water System Acquisitions

The purpose of the acquisition policy is to try to encourage acquisition and consolidation of small water utilities operating in the state. For purposes of this policy, small water utilities are limited to Class D and E water utilities, i.e., less than \$250,000 of operating revenue in the most recent calendar year. Acquisition of small water utilities should result in improved water quality and/or service for the customers.

Decision No. 62993, dated November 3, 2000, established six general conditions a water company must meet to qualify for an acquisition adjustment or rate of return premium. Per that Decision, the acquisition incentive may be granted in one of two ways: (1) recovery of an amount paid in excess of the book value of the acquired company's assets (acquisition adjustment), or (2) a rate of return premium, but not both. This policy develops criteria and procedures for determining the amount of acquisition incentive that will be eligible for recovery in rates following acquisition of a small water utility.

The purchase price for a small water utility could exceed the book value of its plant in service, resulting in a positive acquisition adjustment. This policy applies exclusively to positive acquisition adjustments, and negative acquisition adjustments shall not be recognized for rate-making purposes.

In certain cases, a rate of return premium may be allowed instead of an acquisition adjustment. Once the rate of return percentage is determined, a premium amount will increase that percentage. The premium percentage will be allowed in rates for a period of time that the Commission determines is appropriate to provide an acquisition incentive.

Following is the list of six conditions a company must prove by a preponderance of the evidence in order to obtain an acquisition adjustment or rate of return premium in rates, as well as criteria to meet those conditions.

1. THE ACQUIRED COMPANY IS A CLASS D OR E.

- This policy is to be applied to the acquisition of Class D and E water utilities, i.e., those having less than \$250,000 of operating revenue in the most recent calendar year.

2. THE ACQUISITION WILL NOT NEGATIVELY AFFECT THE VIABILITY OF THE ACQUIRER.

- The acquiring company shall provide documentation that satisfactorily demonstrates its continued financial viability subsequent to the acquisition. Staff will not recommend approval of a proposed acquisition that would be potentially detrimental to an acquirer's financial viability.

3. THE ACQUIRED SYSTEM'S CUSTOMERS WILL RECEIVE IMPROVED SERVICE IN A REASONABLE TIMEFRAME.

- The acquiring company shall submit a plan for improving service to the customers of the acquired system. The plan shall include, but not be limited to, a detailed listing of the current violations and deficiencies of the water company to be acquired, as well as the acquirer's proposed solutions and the related costs. Additionally, the plan must also include a proposal for how the rates of the small water utility's customers will be affected. The acquirer's plan should also provide estimated implementation dates for each system or service improvement. A service improvement plan might include, but is not limited to, the following:
 - a. Delivering water to customers that meets the quality standards of the Arizona Department of Environmental Quality ("ADEQ") and the Safe Drinking Water Act.
 - b. Satisfactory resolution of outstanding violations with ADEQ and the Arizona Department of Water Resources ("ADWR").
 - c. Developing a reliable source of water supply.
 - d. Developing appropriate water storage capacity.
 - e. Improved water pressure, either higher or lower, within the distribution system.
 - f. Replacement of inadequate, insufficient, deteriorated, and/or inefficient infrastructure.
 - g. Improving billing procedures, customer complaint resolution, and service response times.

4. THE PURCHASE PRICE IS FAIR AND REASONABLE (EVEN THOUGH THAT PRICE MAY BE MORE THAN THE ORIGINAL COST LESS DEPRECIATION BOOK VALUE) AND CONDUCTED THROUGH AN ARM'S LENGTH NEGOTIATION.

- One factor that would contribute to recommending an acquisition incentive is if the net plant value is either very small or zero, due to substantially or fully depreciated assets that require replacement. Although the water company assets may reflect zero net book value on the records, the assets in theory still have value due to the fact that they generate a future revenue stream. To determine if the purchase price and resulting acquisition incentive amount is fair and reasonable, Staff's evaluation shall include, but not be limited to, the following criteria:
 - a. The purchase price must be the result of good faith negotiations between the two transacting entities.
 - b. The acquisition must be conducted through an arm's length transaction, and the two parties must not be affiliates as defined by A.A.C. R14-2-801.1.
 - c. Present value of future cash flows.

5. THE RECOVERY PERIOD FOR THE ACQUISITION ADJUSTMENT SHOULD BE FOR A SPECIFIC MINIMUM TIME.

- Staff will evaluate the acquisition adjustment recovery period to be fair and reasonable to both the acquirer, and the customers of the small water utility. The specific recovery period shall be set on a case-by-case basis and shall be consistent with the period over which customers are expected to benefit, as well as mitigate the impact of cost recovery on rates.
- If a rate of return premium is sought by the acquiring company, Staff will determine the premium percentage and recovery period on a case-by-case basis. Recovery via the rate of return premium will be calculated to recoup only the excess of the purchase price over the book value of the plant in service.

6. THE ACQUISITION IS IN THE PUBLIC INTEREST

Staff will investigate the acquirer's compliance history with the ADEQ and the ADWR to determine if it is a fit and proper entity to acquire a small water utility. Acquisition incentives will not be granted to entities that are currently in violation of rules set forth by ADEQ and/or ADWR.

The acquisition of a small water utility would comply with the standard of public interest if the above detailed five conditions are met, and no ADEQ and/or ADWR rule violations are pending. Additionally, the following circumstances may further demonstrate how an acquisition could be in the public interest:

- The small water utility is insolvent, defined as “unable or having ceased to pay debts as they fall due in the usual course of business”.
- The small water utility will have increased opportunities to obtain short-term financing as a result of the acquisition. This will enable the company to make improvements to, and correct deficiencies within its water system that would enable it to serve water that meets the quality standards set forth in the Safe Drinking Water Act.
- Short-term and long-term cost savings can be demonstrated as a result of the acquisition, as well as efficiencies and economies of scale.
- As a result of the acquisition, delinquent remittance of transaction privilege tax and/or property tax by the small water utility to the Arizona Department of Revenue will be satisfied.

PROPOSED PROCEDURE

Once the two entities enter into a transfer/purchase agreement, they will submit a joint application to the Commission pursuant to Arizona Administrative Code Section R14-2-103. The joint application should include the following information:

- a) A Commission approved rate application for water companies with annual gross operating revenues of less than \$250,000 for the small water utility to be acquired as of the most recent fiscal year end, or all the information required in such a rate case application along with a request for a Commission accounting order delineating how the acquisition incentive will be treated.
- b) Financial statements of the acquirer as of the most recent fiscal year end.
- c) Disclosure of transaction as either an asset purchase and Certificate of Convenience and Necessity transfer, or stock purchase.
- d) A copy of the purchase agreement/sale document including the proposed purchase price.
- e) A detailed explanation and supporting evidence to demonstrate how the acquisition meets the six conditions to be eligible for recovery of an acquisition adjustment in rates.
- f) A list and explanation of current known deficiencies of the system to be acquired as well as the acquirer's proposed solutions to remedy the deficiencies, along with the costs, and timeframe for implementing the solutions.
- g) Reconstruction Cost New (RCN) for the small water utility to be acquired or adequate information for an RCN study to be performed.
- h) A detailed calculation of the proposed acquisition adjustment requested to be eligible for recovery in rates, a proposal for its method of recovery, and a calculation of its effect on rates.

Upon submission of the application, Staff will analyze the documentation to determine whether the acquisition meets the six conditions identified in Decision No. 62993, by:

1. Analyzing the company's financial information to determine that it is a Class D or E water utility.
2. Assessing the acquiring entity's financial resources to determine if sufficient financial resources are available to acquire a small water utility without jeopardizing the acquirer's good financial standing.
3. Evaluating the acquirer's proposed actions to assess whether customers of the acquired small water utility will receive improved service within a reasonable timeframe.

4. Evaluating the original cost of the existing plant assets on the acquired utility's books, as well as RCN amounts. Staff will then compare those two amounts with the proposed purchase price to determine if the purchase price is fair and reasonable; if the purchase price was negotiated, and if the sale will be conducted, through an arms length transaction; and what amount of acquisition adjustment or rate of return premium, if any, will be allowed.
5. Classifying the acquisition incentive as either a regulatory asset (acquisition adjustment) or a rate of return premium, to be recovered over a specific time.
6. Reviewing the documentation provided in response to the five conditions set forth, as well as other potential benefits identified by the acquirer and determine if the acquisition meets the criteria of public interest. Staff will also evaluate whether the acquirer is a "fit and proper" entity to purchase a small water utility.
7. Requesting and analyzing other information/data that Staff and/or the Commission deems necessary for a particular case.

ATTACHMENT C

Proposed Policy For Water System Tiered Rate Design

Pricing/rate design is the Commission's primary means of encouraging conservation. The Commission can do this by implementing inverted block rates, i.e., tiered rates. Tiered rates may not be appropriate in all circumstances. Staff will consider the appropriateness of an inverted three-tiered commodity rate structure for all water company rate cases, and if appropriate, will recommend such a tiered rate structure to encourage conservation. The tiers should be designed in a manner that customers who conserve will recognize cost savings, while high water users will pay a greater portion of the costs that increased usage places on the water system. Criteria for evaluating the appropriateness and/or type of tiered rate structure on a case-by-case basis shall include, but not be limited to, the following:

1. Number of service connections on the system.
2. Number of high usage customers on the system.
3. Gallons of average water usage per connection per month.
4. Gallons of median water usage per connection per month.
5. Source of supply.

ATTACHMENT D

Proposed Policy For Central Arizona Project (CAP) Cost Recovery

The consensus of the CAP Working Group is that the Arizona Corporation Commission (Commission) should encourage water companies to retain their Central Arizona Project (CAP) water allocation. The purpose is to allow water companies to accomplish long term planning of their water resource needs for the benefit of their customers. The consensus of the group was that the Commission should accomplish this encouragement as follows:

1. A water company would be allowed to recover CAP costs if it could demonstrate that it needed the CAP allocation to properly serve its customers.
2. The water company must demonstrate that the need would occur by the year 2025.
3. The water company must demonstrate that it will actually be using a reasonable amount of its CAP allocation by 2025.
4. The water company must demonstrate that it will be using all of its CAP allocation by 2034.
5. "Use" will be those methods of using CAP water that are defined as "use" by the Arizona Department of Water Resources.
6. In order to obtain cost recovery, a water company must file a rate case and provide evidence demonstrating items 1 through 4 above.
7. At the time that cost recovery is approved for a water company, cost recovery will depend on how much of company's CAP allocation is actually being used –
 - a. If none of the CAP allocation is actually being used, the company will be allowed to recover dollar for dollar its appropriate CAP expenses, without earning a rate of return. The cost recovery will be split between a charge in the commodity portion of the rate and a CAP Hook-up Fee. The charge in the commodity will be that amount needed to pay the M&I portion of the expense for that amount of CAP water equal to the amount of groundwater actually being used by the current customers. The CAP Hook-up Fee will be calculated as that portion needed to pay the remainder of the M&I charges. This is similar to the method used in the Vail Water Company rate case (Decision No. 62450). If the CAP Hook-up Fee is determined by the Commission to have to be excessive in order to recover all the CAP costs, the

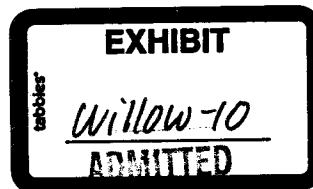
remainder should be deferred and collected later as the company grows and adds additional customers and/or the rate of growth increases to allow the collection of additional CAP Hook-up Fees.

- b. If only a portion of the CAP allotment is being used, cost recovery will be split. For that portion of the CAP allotment not being used, cost recovery will be allowed as explained above (#7a). For that portion of the CAP allotment actually being used, cost recovery will be as with any other used and useful item in a rate case, i.e., the plant needed will be included in rate base and earn a rate of return, while the M&I and OM&R expenses for that portion of the CAP allotment will be recovered as any other expense.
 - c. When all the CAP allotment is being used, cost recovery will be as described in the second half above (#7b), i.e., just like any other plant and expense item that is used and useful.
 - d. For those water companies that have not obtained a specific accounting order from the Commission that details how CAP costs incurred up to this time would be treated and meet items 1 through 4 above, the actual amount of direct costs incurred (i.e., no rate of return or cost of money) should be recovered in rates by some method determined in a rate case, as long as such an allowance is not somehow improper (e.g., retroactive rate making, contrary to some mandatory accounting/rate making principle, etc.).
8. Within 5 years of obtaining approval for cost recovery of the CAP costs, the water company must submit a detailed engineering plan outlining how the water will be put to use.
9. If a water company that has obtained cost recovery from the Commission is not using its total CAP allotment by 2034, that portion not being used shall be sold. If a water company has recovered from ratepayers the cost for retaining that portion of the CAP allocation it sells, all net proceeds shall be refunded to ratepayers in a manner to be determined by the Commission at that time. Similarly, if a water company sells all or any portion of its CAP allocation after recovering from ratepayers the cost to retain the portion it sells, all net proceeds shall be refunded to ratepayers.



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Douglas A. Ducey
Governor

David P. Tenney
Director

November 4, 2015

Timothy J. Sabo
Snell & Wilmer
One Arizona Center
400 E. Van Buren Street, Suite 1900
Phoenix, Arizona 85004

Re: Willow Valley Water Co., Inc. – First Set of Data Requests to RUCO –
Docket Nos. W-01303A-15-0131 and W-01732A-15-0131

Dear Mr. Sabo:

Enclosed are RUCO's Responses to Willow Valley Water Company's First Set of Data Requests.

If you have any questions, please contact me at 602-364-4839.

Sincerely,

Daniel W. Pozefsky
Chief Counsel

Enc.

RUCO responses to Global's data requests:

Willow 1.1 Please provide all work-papers associated with RUCO's testimony.

No schedules were used, all testimony and exhibits have been included in Mr. Michlik's testimony.

Willow 1.2 Admit that EPCOR Water Arizona Inc. has the management capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO's job is not to oversee or evaluate Company management capabilities to own and operate the Willow Valley system, nor is it prescribed in the Arizona administrative code. If the Company needs assistance in evaluating its management, financial, or technical capabilities, it can hire an outside consultant to resolve any issues it may have.

Willow 1.3 Admit that EPCOR Water Arizona Inc. has the financial capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.2. In addition, the Company objected to RUCO 4.03 which asked for updated financial information related to dividend payouts, not to mention most of the other financial data in this document is subject to a confidentiality agreement. So, even if the Commission were to ask RUCO to do some type of financial analysis to assess the Company's financial capability the Company would have to provide RUCO with this information.

Willow 1.4 Admit that EPCOR Water Arizona Inc. has the technical capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.2.

Willow 1.5 List each decision of the Arizona Corporation Commission, of which RUCO is aware, where the Commission approved a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of RUCO Witness Michlik).

RUCO is not aware of any Commission approved regulatory liability for ADIT in an asset transfer.

Willow 1.6 To the knowledge of RUCO, list each prior docket where RUCO proposed a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of RUCO Witness Michlik).

RUCO is not aware of any recommendations that it has made in the past regarding this issue at this juncture.

Willow 1.7 Admit that if a regulatory liability is created for ADIT (as proposed in the testimony of RUCO Witness Michlik), that BWAZ will be required to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l) - 1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO cannot admit or deny at this point as RUCO is researching this issue, and will supply a supplemental response at a later date.

Willow 1.8 Provide RUCO's calculation of the ratepayer impact if EWAZ is forced to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§68(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l) - 1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.7.

Willow 1.9 Regarding Attachment C to Mr. Michlik's Direct Testimony (Staff Memorandum dated June 29, 2015), admit that none of the proposed policy statements recommended in that memorandum were ever adopted as formal policy statements by the Commission. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO cannot admit or deny at this point as RUCO is researching this issue, and will supply a supplemental response at a later date.

Willow 1.10 Regarding the March 19, 2012 Commission Staff Memorandum attached to Mr. Michlik's Direct Testimony, admit that the Arizona Corporation Commission has not adopted the recommendations set forth in that memorandum. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.09

Willow 1.11 Regarding the article on "Tolleson to get \$4.3M settlement in water treatment plant dispute" (Attachment D to Mr. Michlik's Direct Testimony), please provide the name of the publication this article appeared in, the date, and the page.

West Valley View, Friday, June 12, 2015 page 1.

Willow 1.12 Regarding Mr. Michlik's statement that the "legal disputes" referenced in Attachment D to his Direct Testimony "could affect the Company's financial viability". (Page 16, lines 17 to 19). Please provide the following:

- A. Mr. Michlik's financial analysis of how EPCOR Water Arizona Inc.'s financial viability could be impacted by the referenced legal disputes.
- B. Did Mr. Michlik review any other documents other than the news articles in Attachment D in researching the impact of these legal disputes on EPCOR Water Arizona Inc.?
 - (i) For example, Did Mr. Michlik review legal pleadings?
 - (ii) Did he review notes to financial statements regarding the litigation?
- C. Provide Mr. Michlik's analysis of EPCOR Water Arizona Inc.'s maximum financial exposure in these legal disputes.

RUCO's analysis is very simple, if the Company is still involved in a series of legal disputes, and has to pay out millions of dollars that means the Company has less money to invest in this water system.

Willow 1.13 Regarding Attachment F to Mr. Michlik's Direct Testimony, provide the following information:

- A. Any prior public versions of this document.
- B. Who compiled the document?
- C. When the document was compiled.
- D. Describe the methodology used to prepare the document.
- E. How many of these states have as many water companies as Arizona?

In response to B: The information was provided by the National Association of Water Companies ("NAWC").

RUCO does not have any information relating to questions A, C, D, or E. Since NAWC is the trade group that represents Global. RUCO suggests that the Company ask the questions to NAWC.

Willow 1.14 Regarding Mr. Michlik's statement that Global Water Resources, Inc. is a class A utility", [Michlik Direct at page 3, line 10-13 and page 16, line 12) admit that Global Water Resources, Inc. is a "Public Utility Holding Company" as defined in A.A.C. RI4-2-801, and not a "Class A" utility as defined in A.A.C. RI4-2-103. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO's classification was based on Staff's sufficiency letter dated November 7, 2012. Upon further review, RUCO agrees that Global Water Resources, Inc. is a Public Utility Holding Company.

Willow 1.15 Regarding Mr. Michlik's statement that Global Water Resources, Inc. is an Arizona corporation, admit that Global Water Resources, Inc. is a Delaware corporation. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

Global Water Resources, Inc. probably was incorporated in Delaware, and does business in Arizona, and has offices in the Phoenix Area. Further, from Global Water Resources website "Global Water Resources Corp (GWRC) was incorporated in British Columbia to acquire shares of U.S. based Global Water and to actively participate in the management, business and operations of Global Water through its representation on the board of directors of Global Water and its shared management of Global Water. GWRC owns an approximate 48.1% interest in Global Water."

Willow 1.16 Mr. Michlik's Direct Testimony states that "The Company's proposed acquisition adjustment seems very similar to a System Improvement Benefits ("SIB") Mechanism in which utility plant is built between rate cases. The Arizona Court of Appeals subsequently determined that the SIB was illegal (see Attachment A). This is basically the same situation in this case as the acquisition premium as proposed will create rate increases between rate cases without a fair value determination" (Michlik Direct at page 7, lines 12 to 18). If the SIB mechanism and EWAZ's proposed acquisition adjustment mechanism are illegal because they change rate base outside of a rate case, please explain how RUCO's proposed "ratepayer protection mechanism"

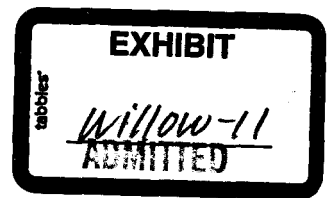
(Michlik Direct at page 20, lines 20-21), which reduces rate base outside a rate case, is legal.

RUCO believes the initial premise to the question is no longer valid. The Company has clarified or modified its proposed acquisition adjustment in which it states it will not ask for rates outside of a rate case, but will ask for the premium be recovered in a rate case (see Testimony of EPCOR witness Sarah Mahler), thus eliminating RUCO's concern over the fair value determination. RUCO's ratepayer protection mechanism does not adjust outside of a rate case – there is no fair value issue with RUCO's recommended treatment of the acquisition premium.



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Douglas A. Ducey
Governor

David P. Tenney
Director

November 18, 2015

Timothy J. Sabo
Snell & Wilmer
One Arizona Center
400 E. Van Buren Street, Suite 1900
Phoenix, Arizona 85004

Re: Willow Valley Water Co., Inc. – First Set of Data Requests to RUCO –
Docket Nos. W-01303A-15-0131 and W-01732A-15-0131.

Dear Mr. Sabo:

Enclosed are RUCO's Updated Responses to Willow Valley Water Company's First Set of Data Requests.

If you have any questions, please contact me at 602-364-4839.

Sincerely,

Daniel W. Pozefsky
Chief Counsel

RUCO's Updated responses to Global's data requests:

Willow 1.7 Admit that if a regulatory liability is created for ADIT (as proposed in the testimony of RUCO Witness Michlik), that BWAZ will be required to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l) - 1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

This request cannot be either affirmed or denied at this time based on the available information. RUCO notes that while Global/Willow Valley has presented rebuttal testimony on income tax normalization by Mr. Paul Walker (who admits that he is neither an attorney or a tax accountant¹ or a tax expert² and who states that he is "not opining on the tax consequences"³), there has been no Private Letter Ruling specifically addressing the facts and circumstances of Applicants' proposed transaction and RUCO's proposed use of a Regulatory Liability as a condition of approval of the Applicants' proposed transaction. For further explanation, see the Surrebuttal testimony of Ralph C. Smith.

Willow 1.8 Provide RUCO's calculation of the ratepayer impact if EWAZ is forced to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l) - 1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

Objection: the data request asks for a calculation that RUCO has not made, which is not in RUCO's possession or the possession of RUCO's witnesses, and which could presumably be made by Global (or EWAZ) if Global (or EWAZ) believed such calculation to be relevant to any issues in this proceeding.

Willow 1.9 Regarding Attachment C to Mr. Michlik's Direct Testimony (Staff Memorandum dated June 29, 2015), admit that none of the proposed policy statements recommended in that memorandum were ever adopted as formal policy statements by the Commission. If your response is anything other than an unqualified admission,

¹ Walker rebuttal page 6, line 3.

² Walker rebuttal page 7, line 7.

³ Walker rebuttal page 6, line 4.

provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

Deny see the Surrebuttal Testimony of Jeffrey M. Michlik.

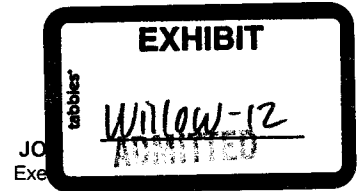
Willow 1.10 Regarding the March 19, 2012 Commission Staff Memorandum attached to Mr. Michlik's Direct Testimony, admit that the Arizona Corporation Commission has not adopted the recommendations set forth in that memorandum. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

Deny See the Surrebuttal Testimony of Jeffrey M. Michlik.

COMMISSIONERS
SUSAN BITTER SMITH – Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE



ARIZONA CORPORATION COMMISSION



November 5, 2015

NOV 09 2015

SNELL & WILMER

Timothy Sabo
Snell & Wilmer
One Arizona Center
400 East Van Buren Street, Suite 1900
Phoenix, AZ 85004

tsabo@swlaw.com

Re: Staff's Responses to Willow Valley Water Co., Inc.'s First Set of Data Requests to Staff
Docket No. W-01732A-15-0131

Dear Mr. Sabo:

Enclosed is Staff's Responses to Willow Valley Water Co., Inc.'s First Set of Data Requests to Staff.

Sincerely,

A handwritten signature in black ink, appearing to read "R. R. Mitchell".

Robin R. Mitchell
Attorney, Legal Division
(602) 542-3402

RRM:mam
Enclosure

cc: Darron Carlson (Via Email Only)

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.1 Please provide all work papers associated with Staff's testimony.

RESPONSE: Sending under separate cover.

RESPONDENT: Darron Carlson

The Going Concern Principle

The going concern principle is the assumption that an entity will remain in business for the foreseeable future. Conversely, this means the entity will *not* be forced to halt operations and liquidate its assets in the near term at what may be very low fire-sale prices. By making this assumption, the accountant is justified in deferring the recognition of certain expenses until a later period, when the entity will presumably still be in business and using its assets in the most effective manner possible.

An entity is assumed to be a going concern in the absence of significant information to the contrary. An example of such contrary information is an entity's inability to meet its obligations as they come due without substantial asset sales or debt restructurings. If such were not the case, an entity would essentially be acquiring assets with the intention of closing its operations and reselling the assets to another party.

If the accountant believes that an entity may no longer be a going concern, then this brings up the issue of whether its assets are impaired, which may call for the write-down of their carrying amount to their liquidation value. Thus, the value of an entity that is assumed to be a going concern is higher than its breakup value, since a going concern can potentially continue to earn profits.

The going concern concept is not clearly defined anywhere in generally accepted accounting principles, and so is subject to a considerable amount of interpretation regarding when an entity should report it. However, generally accepted auditing standards (GAAS) *do* instruct an auditor regarding the consideration of an entity's ability to continue as a going concern.

The auditor evaluates an entity's ability to continue as a going concern for a period not greater than one year following the date of the financial statements being audited. The auditor considers (among other issues) the following items in deciding if there is a substantial doubt about an entity's ability to continue as a going concern:

- Negative trends in operating results, such as a series of losses

- Loan defaults by the company
- Denial of trade credit to the company by its suppliers
- Uneconomical long-term commitments to which the company is subjected
- Legal proceedings against the company

If there is an issue, the audit firm must qualify its the audit report with a statement about the problem.

It is possible for a company to mitigate an auditor's view of its going concern status by having a third party guarantee the debts of the business or agree to provide additional funds as needed. By doing so, the auditor is reasonably assured that the business will remain functional during the one-year period stipulated by GAAS.

Similar Terms

The going concern principle is also known as the *going concern concept*.

1. Staff should evaluate whether to support the transfer or just recommend against the acquisition premium and set forth some conditions. It is not in the public interest to reward companies with significant rate increase and a SIB only to have them do nothing to improve their operations.
 - a. Global's lack of action to further the public interest may be further compounded by yet unknown conditions that might be disclosed in a review of Epcor's due diligence workpapers and the review of the board minutes of both companies. (See 8 & 9 below).
 - b. Global's compliance filing of May 29, 2015 in 12-0309 et al indicates that very little has been done to reduce water loss in this and other systems.
 - c. Refusal to provide due diligence workpapers prevents Staff from verifying that any significant due diligence was performed.
 - d. Refusal to provide due diligence workpapers prevents Staff from evaluating any known detriments or benefits to ratepayers, as would be discussed in due diligence workpapers.
 - e. A recommendation against approving the transfer should be accompanied by Staff concerns about the filing and items to be considered in the event that the ACC does approve the transfer.
2. Prior rate case 12-0309 et al, Decision No. 74364, Willow Valley was awarded a rate increase of \$404,269, or 57.53%, a SIB, and a rate design heavily weighted with amounts from the monthly minimums.
 - a. None of this has resulted in any improvements such as SIB related or any other repairs. It appears that the rate increase has benefitted the company only.
 - b. Global had argued that SIB was necessary and would result in reductions to water loss but has failed to effect any repairs.
 - c. Any changes to the existing SIB as part of this case would represent changes to a previously approved SIB outside of a rate case.
3. The transfer of assets will result in a rate base supported by a capital structure / COE that would result in savings for the ratepayers. Epcor is not willing to share benefits with ratepayers. This would save ratepayers appx \$40K per year. In response to GWB 1.3, EWAZ touts rate stability as a benefit to ratepayers from the sale. "Rate Stability: EWAZ is not seeking, as part of this Application, to change any of the rates previously approved by

the Commission. This will limit customer confusion or concern regarding the new ownership structure in Willow Valley.”

4. Willow Valley is not a small troubled company, since its parent is well capitalized and has access to the financial markets.
5. GWB 1.10 is unresponsive. Operational concerns should be answered more fully with current information from Global instead of just sending in testimony from 2012 case. If Global does not want to answer, it's another reason to recommend denial.
6. Companies seek a 10% acquisition premium based on an overstated rate base. Slight discrepancy in response to GWB 1.3. Text of 1.3 states rate bases at \$2,268,031 while supporting schedule shows rate base of \$2,273,846, a difference of \$5,815. More important concern is that the rate base schedules submitted in response to GWB 1.6 shows current rate base of \$1,964,397. Significant difference due to the exclusion of ADIT from the rate base used in the rate base used by the Companies in determining the sale price of \$2,494,834, meaning that the acquisition premium is more correctly stated at \$530,537 or 27 percent. The ADIT liability represents a reduction to rate base for taxes funded by rates but not yet remitted to the taxing entities. Failure to recognize the ADIT liability deprives ratepayers of the benefits for taxes already paid and funded through rates but not remitted by Global. Per response to GWB 1.6, the ADIT as of December 31, 2014 is \$260,224 which is an ADIT liability of \$293,862 net of an ADIT receivable of \$33,638. The Seller's rate base schedule 3.2 also includes \$19,767 for "Utility Plant Acquisition Adjustment" (not previously approved? And its inclusion in the current calculation effectively does approved it) and fails to include Customer Meter Deposits of \$31,898. The buyer will be responsible to refund Customer Meter Deposits as needed and it is unclear why these amounts should be excluded from the calculation. If meter deposits are not intended to transfer for purposes of calculating the sales price, the value of the meter deposits should be imputed for ratemaking purposes and for purposes of calculating the acquisition premium. Failure to recognize meter deposits also deprives ratepayers of the reduction to the price and in a rate case, fails to recognize the non-investor supplied capital.
7. GWB 1.11 Companies state that there are no employees directly employed by Willow and are employees of Global Water. Question is unresponsive in terms of other indirect employment and related costs and if the transfer will harm or help ratepayers.
8. Due Diligence workpapers – EWAZ objected to providing these. Staff is therefore unable to verify that any due diligence has been performed or to evaluate the scope of the review. Staff is further unable to determine whether any potential benefits or detriment to ratepayers are expected or anticipated.
9. Board of Directors minutes and presentations – Companies object to providing these. Staff is unable to confirm the support of either company's board. Staff is further unable to

determine whether any potential benefits or detriment to ratepayers are expected or anticipated.

Taxable asset acquisitions

Recurring issue

- Buyer's ratemaking treatment of seller's pre-disposition "regular" deferred tax liabilities in a taxable asset acquisition
 - Various transaction forms
- Federal income tax consequences

– Seller's pre-disposition DTL reverses as a result of the taxable gain

– Buyer re-sets DTLs to zero

- May the buyer reduce its rate base by the seller's pre-disposition deferred tax liability (DTL)

– By an amount that happens to equal the seller's DTL? *No*

– May buyer reduces its revenue requirement by an amount that approximates the effect of seller's pre-acquisition DTL on its

return?

No

32018 LTR Rev Rul 2015-14

Deferred tax consistency requirement

Section 168(i)(9)(B)

- One way in which the basic normalization rule of Section 168(i)(9)(A) is not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of the basic normalization rule
- Estimates or projections of:
 - Tax expense
 - Depreciation expense
 - Deferred tax liability
 - Rate base

Must be used consistently for all elements

Internal Revenue Service

Number: **201541010**

Release Date: 10/9/2015

Index Number: 167.22-01

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B06

PLR-143241-14

Date:

July 06, 2015

LEGEND:

Taxpayer =

Parent =

State A =

State B =

Commission A =

Commission B =

Commission C =

Operator =

Year A =

Case A =

Case B =

Case C =

Date X =

Director =

Dear :

This letter responds to Parent's request, made on behalf of Taxpayer, dated January 9, 2015, for a ruling on the application of the normalization rules to certain regulatory procedures applied in State as described below.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is primarily engaged in the business of generating, transmitting, distributing, and selling electric power to customers in State A and State B. It is subject to regulation by Commission A, Commission B, and Commission C with respect to terms and conditions of services, including the rates it may charge for its services. All three Commissions establish Taxpayer's rates based on Taxpayer's costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

The law of State A provides a process under which a utility may recover its costs relating to projects such as new electric generation facilities as a stand-alone rate adjustment added to customers' base rates. As relevant to this ruling request, the process for setting the rates involves two components. First, a taxpayer files estimated projections of all factors, including Accumulated Deferred Federal Income Taxes (ADFIT), relevant to the costs associated with the facility that is the subject of the rate adjustment. Rate base for this purpose is calculated using an average of the thirteen projected end of month balances of the components of rate base. The rate adjustment computed using these projections goes into effect at the beginning of the test period. The test period is a twelve month period. The anticipated collections from rate payers, the actual cost incurred with respect to the generating facility and any differences between anticipated amounts and actual amounts are reconciled by a "true-up" mechanism at the end of the test year. Under this mechanism, the reconciliation amount is either charged to ratepayers (if actual revenues are below estimates) or credited to ratepayers (if actual revenues exceed estimates) as part of the rates established for the forthcoming rate year. For both under and over collections, a carrying charge is imposed.

Taxpayer owns and operates electric transmission lines in several states, including State A and State B. These lines are integrated into Operator, a regional transmission operator. The rates that Taxpayer may charge its customers for these transmission services are set using a formula approved by Commission C. The formula rates are calculated using a methodology similar to that used to calculate the rate adjustments, inasmuch as the formula rates are calculated using projected costs to establish rates during the period for which rates are being set and a true-up based on over or under recoveries that are reflected in a subsequent rate year. The rates are determined by application of the formula approved by Commission C and go into effect with no additional action by Commission C.

Taxpayer claims accelerated depreciation on its tax returns to the extent permitted by the Internal Revenue Code. Taxpayer normalizes the federal income taxes deferred as a result of its use of accelerated depreciation and thus maintains an ADFIT balance on its regulatory books. In ratemaking proceedings before Commission A to authorize rate adjustments as well as in calculation of the formula rates, rate base is reduced by the calculated ADFIT balance. In calculating its ADFIT balance for purposes of both the projection and true-up elements of the rate adjustment

calculations, Taxpayer followed the same averaging conventions it used for the other components of rate base. However, for prior formula rate filings, Taxpayer had calculated its ADFIT balance by an average of the beginning and ending balances notwithstanding that it used a 13-month average for computation of the plant portion of rate base. In those prior cases, the averages are calculated in accordance with the provisions of the Commission-approved template and the differences in averaging conventions are required by the regulations adopted by Commission C.

Section 1.167(l)-1(h)(6) of the Income Tax Regulations requires that a proration methodology be used by Taxpayer to calculate its applicable ADFIT balance for future test periods. Prior to Year A, Taxpayer had not used the proration methodology either in estimating its projected ADFIT balance or for the calculation of ADFIT for purposes of the true-up. Members of Taxpayer's tax department became concerned about the normalization implications of not using the proration formula during Year A. In filing Case A, Case B, and Case C, Taxpayer incorporated the proration methodology into the calculation of its projected ADFIT balance. In addition, Taxpayer incorporated the proration methodology into the calculation of the true-up in Case B. The staff of Commission A did not agree that the test period used for the rate adjustment ratemaking was a future test period and therefore asserted that the proration methodology was not required. In each of these cases, Commission A approved the use of the proration methodology in the projected ADFIT balance but denied its use in the true-up. When Commission A approved the use of the proration methodology for the projected ADFIT balance, it revised a portion of the Taxpayer's cash working capital allowance to reflect the adoption of the proration methodology. The adjusted portion was intended to compensate Taxpayer for the lag in time between when expenditures are made for services by Taxpayer and when collections for those services are received by Taxpayer. Commission A concluded that the item in the cash working capital allowance was duplicative of the effect of the proration methodology and was thus unnecessary. Due to the uncertainty surrounding the application of the proration methodology and the adjustment to cash working capital, Commission A directed Taxpayer to seek this ruling from the Internal Revenue Service.

Both Commission A and Commission C at all times have required that all public utilities under their respective jurisdictions use normalized methods of accounting.

Taxpayer requests that we rule as follows:

1. The proration methodology requirement does not apply to stand-alone rate adjustment ratemaking and to the Commission C formula rates even if they involve future test periods.
2. The estimated projection component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.

3. The true-up component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.
4. In Taxpayer's stand-alone rate adjustment proceedings, an adjustment to eliminate from the Taxpayer's cash working capital allowance any provision for accelerated depreciation-related ADFIT if the proration methodology is employed does not conflict with the normalization rules.
5. In order to comply with the consistency requirement of the normalization rules, it is not necessary that the Taxpayer use the same averaging convention it uses in computing the other elements of rate base in computing its ADFIT balance for purposes of the formula rates.
6. If the Service rules adversely with respect to Rulings 1, 2, or 3, above, any failure by Taxpayer to employ the proration methodology prior to the proceedings in Cases A, B, or C or the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules requiring sanctions for such violation.
7. In the event that the Service rules adversely with respect to Ruling 5, above, Taxpayer's failure to comply with the consistency requirement in connection with its formula rates prior to the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules.

Law and Analysis

Issues 1 and 2

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the

meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 1.167(l)-1(h)(6) sets forth additional normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in section 1.167(l)-1(a)(1), the rules provided in section 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base

exclusion amount using projected data then it must use the formula provided in section 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in section 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) in resolving the timing issue has been questioned by its failure to define some key terms. Nowhere does this provision state what is meant by the terms "historical" and "future" in relation to the period for determining depreciation for ratemaking tax expense (the "test period"). One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization "in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of section 1.167(l)-1(h)(6)(ii) of the regulations is consistent with the purpose of normalization, which is to preserve for

regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on projected (future estimated) data is prorated according to the formula in section 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

There are two kinds of ratemaking at issue here, with identical components. For both the stand-alone rate adjustment and the formula rates, Taxpayer estimates the various components of rate base. Rates go into effect as of the beginning of the service year.¹ As such, the rates are in effect during the test year and the proration formula must be used. The addition of the true up increases the ultimate accuracy of the rates but does not convert a future test period into a historical test period as those terms are used in the normalization regulations. Therefore, Taxpayer is required to apply the proration formula in calculating accumulated deferred income taxes for purposes of calculating rate base.

Issue 3

¹ We note that, because Taxpayer is using estimated data for the test period, the test period at issue here constitutes a "future test period" under the first interpretation discussed above as well.

As discussed above, where a taxpayer computes its ratemaking tax expense and rate base exclusion amount using projected data then must use the proration formula provided in section 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in section 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

In contrast to the projections discussed above, the true-up component is determined by reference to a purely historical period and there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. In calculating the true-up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.

Issue 4

In Taxpayer's stand-alone rate adjustment proceedings, Commission A adjusted the already-approved cash working capital allowance specifically to mitigate the effect of the use of the proration methodology, finding the effects duplicative. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). Here, Commission A adjusted the cash working capital allowance specifically to mitigate the effect of the application of the proration methodology. This is inconsistent with the normalization rules. We do not hold that the normalization rules require a similar type of cash working capital adjustment in all cases; we hold only that, where, as here, it is adjusted or removed in an attempt to mitigate the effects of the

application of the proration methodology or similar normalization rule, that adjustment or removal is not permitted under the normalization rules.

Issue 5

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is

also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

In order to satisfy the requirements of §168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. Here, rate base, depreciation expense, and accumulated deferred income taxes are all calculated in consistent fashion – all are averaged over the same period. While there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and ADFIT on the other, for purposes of §168(i)(9)(B), it is sufficient that both are determined by averaging and both are determined over the same period of time. Thus, the calculation of average rate base and accumulated deferred income taxes as described above complies with the consistency requirement of §168(i)(9)(B).

Because of the conclusion reached above, Taxpayer's seventh issue is moot and will not be considered further.

Issue 6

Because the Service has ruled in Issue 1 and 2 that Taxpayer was required to use the proration formula applicable to future test periods for the projected revenue requirement, prospectively adhering to the Service's interpretation of § 1.167(l)-1(h)(6)(ii) require adjustments to conform to this ruling. Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered. Specifically, the current timing of Taxpayer's stand-alone rate adjustment filings with Commission A will accommodate all adjustments or corrections to any prior estimated projections or true-ups necessary to conform to the requirements of this ruling in rates having an effective date no later Date X, including Case A, Case B, and Case C. In addition, Taxpayer has already sought an order from Commission C to make the necessary changes to the rate templates, not simply unilaterally adjusting the calculations (or the manner in which the templates are completed) in the next annual projections or true-up adjustments. If Taxpayer must request these changes through a filing with Commission C, Taxpayer has represented that it will make a filing with Commission C to amend its formula rate template within six months of receipt of this ruling letter, requesting that Commission C apply a methodology in accordance with this letter using an effective date of the first month following the date of the filing made with Commission C. Following Commission C's order in that filing, Taxpayer will prospectively apply the methodology consistent with

this letter approved by Commission C. Until Commission C acts on the filing, Taxpayer will continue to use the methodology described above.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit, Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Here, Taxpayer has received stand-alone rate adjustments from Commission A without application of the proration methodology as required. In addition, Taxpayer used a template approved by Commission C to calculate formula-based rates. Both Commission A and Commission C have, at all times, required that utilities under their respective jurisdictions use normalization methods of accounting. Taxpayer also intended at all times to comply with the normalization rules. As concluded above, Taxpayer was required to use the proration methodology in these ratemaking proceedings. However because Commissions A and C as well as Taxpayer at all times sought to comply, and because Taxpayer will take the corrective actions described above, it is not currently appropriate to apply the sanction of denial of accelerated depreciation to Taxpayer.

Conclusions

1. The proration methodology requirement applies to all future test periods.
2. The estimated projection component of both the stand-alone rate adjustment ratemaking and the formula rate does employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is required to use the proration methodology in order to comply with the normalization rules.
3. The true-up component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.
4. In Taxpayer's stand-alone rate adjustment proceedings, an adjustment to eliminate from the Taxpayer's cash working capital allowance any provision for accelerated depreciation-related ADFIT if the proration methodology is employed does conflict with the normalization rules.
5. In order to comply with the consistency requirement of the normalization rules, it is not necessary that the Taxpayer use the same averaging convention it uses in computing the other elements of rate base in computing its ADFIT balance for purposes of the formula rates.

6. The Service rules adversely with respect to Rulings 1 and 2, above. Any failure by Taxpayer to employ the proration methodology prior to the proceedings in Cases A, B, or C or the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules requiring sanctions for such violation.
7. Because the Service rules favorably with respect to Ruling 5, above, Taxpayer's requested Ruling 7 is moot.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.2 Please identify the witness who will take Mr. Becker's place and provide their qualifications.

RESPONSE: Darron Carlson who is employed by the Utilities Division of the Commission as a Public Utilities Analyst Manager. He has been employed with the Utilities Division since September of 1991. He holds a Bachelor of Arts degree in both Accounting and Business Management from Northeastern Illinois University in Chicago, Illinois. He has participated in quite a number of seminars and workshops related to utility ratemaking, cost of capital, income taxes, and similar issues. These have been sponsored by organizations such as the National Association of Regulatory Commissioners ("NARUC"), Duke University, Florida State University, Michigan State University, New Mexico State University, and various other organizations.

RESPONDENT: Darron Carlson

Willow 1.3 Admit that EPCOR Water Arizona Inc. has the management capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: Staff has made no statement or indication that EPCOR is not capable.

RESPONDENT: Darron Carlson

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.4 Admit that EPCOR Water Arizona Inc. has the financial capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: **See response to Willow 1.3.**

RESPONDENT: **Darron Carlson**

Willow 1.5 Admit that Epcor Water Arizona Inc. has the technical capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: **See response to Willow 1.3.**

RESPONDENT: **Darron Carlson**

Willow 1.6 List each decision of the Arizona Corporation Commission, of which Staff is aware, where the Commission approved a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of Staff Witness Becker).

RESPONSE: **Staff is not aware of any.**

RESPONDENT: **Darron Carlson**

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.7 To the knowledge of Commission Staff, list each prior docket where Arizona Corporation Commission Staff proposed a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of Staff Witness Becker).

RESPONSE: See response to Willow 1.6.

RESPONDENT: Darron Carlson

Willow 1.8 Admit that if a regulatory liability is created for ADIT (as proposed in the testimony of Staff Witness Becker), that EWAZ will be required to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(1)-1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: Staff has determined that its recommendation to create a regulatory liability to replace the ADIT balance may result in a violation of the IRS normalization rules and therefore withdrawal of this recommendation is under internal review.

RESPONDENT: Darron Carlson

Willow 1.9 Provide Staff's calculation of the ratepayer impact if EWAZ is forced to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(1)-1, (together, Depreciation Normalization Rules)].

RESPONSE: See response to Willow 1.8

RESPONDENT: Darron Carlson

BEFORE THE ARIZONA CORPORATION COMMISSION

SUSAN BITTER SMITH - Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE

IN THE MATTER OF THE JOINT APPLICATION OF
WILLOW VALLEY WATER CO., INC. AND EPCOR
WATER ARIZONA, INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF CERTIFICATE
OF CONVENIENCE AND NECESSITY

DOCKET NO. W-01732A-15-0131
DOCKET NO. W-01303A-15-0131

SURREBUTTAL TESTIMONY
OF
RALPH C. SMITH
ON BEHALF OF THE
RESIDENTIAL UTILITY CONSUMER OFFICE
NOVEMBER 13, 2015

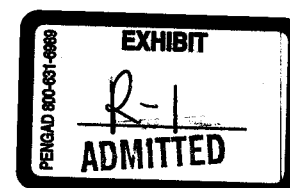


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ATTACHMENTS

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Staff responses to Willow Valley Data Request Set 1	RCS-2
Private Letter Ruling 9447009 (11/25/1994).....	RCS-3
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1 **I. INTRODUCTION**

2 **Q. Please state your name, position, and business address.**

3 A. Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC,
4 15728 Farmington Road, Livonia, Michigan 48154.

5
6 **Q. Please describe Larkin & Associates.**

7 A. Larkin & Associates is a Certified Public Accounting and Regulatory Consulting firm.
8 The firm performs independent regulatory consulting primarily for public service/utility
9 commission staffs and consumer interest groups (public counsels, public advocates,
10 consumer counsels, attorneys general, etc.). Larkin & Associates has extensive experience
11 in the utility regulatory field as expert witnesses in over 600 regulatory proceedings
12 including numerous electric, gas, telephone, and water and sewer matters.

13
14 **Q. Mr. Smith, please summarize your educational background.**

15 A. I received a Bachelor of Science degree in Business Administration (Accounting Major)
16 with distinction from the University of Michigan - Dearborn, in April 1979. I passed all
17 parts of the Certified Public Accountant ("C.P.A.") examination in my first sitting in 1979,
18 received my CPA license in 1981, and received a certified financial planning certificate in
19 1983. I also have a Master of Science in Taxation from Walsh College, 1981, and a law
20 degree ("J.D.") cum laude from Wayne State University, 1986. In addition, I have
21 attended a variety of continuing education courses in conjunction with maintaining my
22 accountancy license. I am a licensed C.P.A. and attorney in the State of Michigan. I am
23 also a Certified Financial Planner™ professional and a Certified Rate of Return Analyst
24 ("CRRA"). Since 1981, I have been a member of the Michigan Association of Certified
25 Public Accountants. I am also a member of the Michigan Bar Association and the Society
26 of Utility and Regulatory Financial Analysts ("SURFA"). I have also been a member of

1 the American Bar Association ("ABA"), and the ABA sections on Public Utility Law and
2 Taxation.

3
4 **Q. Please summarize your professional experience.**

5 A. Subsequent to graduation from the University of Michigan, and after a short period of
6 installing a computerized accounting system for a Southfield, Michigan realty
7 management firm, I accepted a position as an auditor with the predecessor CPA firm to
8 Larkin & Associates in July 1979. Before becoming involved in utility regulation where
9 the majority of my time for the past 36 years has been spent, I performed audit,
10 accounting, and tax work for a wide variety of businesses that were clients of the firm.

11 During my service in the regulatory section of our firm, I have been involved in
12 rate cases and other regulatory matters concerning electric, gas, telephone, water, and
13 sewer utility companies. My present work consists primarily of analyzing rate case and
14 regulatory filings of public utility companies before various regulatory commissions, and,
15 where appropriate, preparing testimony and schedules relating to the issues for
16 presentation before these regulatory agencies.

17 I have performed work in the field of utility regulation on behalf of industry, state
18 attorneys general, consumer groups, municipalities, and public service commission staffs
19 concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona,
20 Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Indiana,
21 Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota,
22 Mississippi, Missouri, New Jersey, New Mexico, New York, Nevada, North Carolina,
23 North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee,
24 Texas, Utah, Vermont, Virginia, Washington, Washington D.C., West Virginia, and
25 Canada as well as the Federal Energy Regulatory Commission and various state and
26 federal courts of law.

1
2 **Q. Have you prepared an attachment summarizing your educational background and**
3 **regulatory experience?**

4 A. Yes. Attachment RCS-1 provides details concerning my experience and qualifications.
5

6 **Q. On whose behalf are you appearing?**

7 A. I am appearing on behalf of the Residential Utility Consumer Office ("RUCO").
8

9 **Q. Have you previously testified before the Arizona Corporation Commission?**

10 A. Yes. I have previously testified before the Commission on a number of occasions. As
11 illustrative examples, in 2000, I filed testimony on behalf of the Commission Utilities
12 Division Staff in Docket No. T-1051B-99-0497, involving the merger of the parent
13 companies of Qwest Communications Corporation, LCI International Telecom Corp. and
14 U.S. West Communications, Inc. I testified before the Commission in Docket No. E-
15 01345A-06-0009, involving an emergency rate increase request by Arizona Public Service
16 Company ("APS" or "Company"); APS' Docket Nos. E-01345A-05-0816, E-01345A-05-
17 0826, and E-01345A-05-0827, concerning proceedings involving APS base rates and
18 other matters; Docket No. E-01345A-08-0172, concerning an emergency rate increase and
19 general rate case request; and the most recent APS case, Docket No. E-01345A-11-0224.
20 I also testified before the Commission in UNS Gas, Inc. rate cases, Docket Nos. G-
21 04204A-11-0158, G-04204A-08-0571, G-04204A-06-0463, G-04204A-06-0013 and G-
22 04204A-05-0831; in UNS Electric, Inc. rate cases, Docket Nos. E-04204A-06-0783 and
23 E-04204A-12-0504; and in Southwest Gas Corporation rate cases, Docket Nos. G-
24 01551A-07-0504 and G-01551A-10-0458. I testified before the Commission in the
25 Arizona-American Water Company in Docket Nos. W-01303A-09-0343 and SW-01303A-
26 09-0343. I have also presented testimony in Tucson Electric Power Company rate cases,

1 Docket Nos. E-01933A-07-0402 and E-01933A-12-0291, among others. I also testified in
2 the reorganization of UNS Energy Corporation in Docket Nos. E-04230A-14-0011 and E-
3 01933A-14-0011. Most recently, I testified before the Commission on behalf of RUCO in
4 the EPCOR Water Arizona, Inc. rate case, Docket No. WS-01303A-14-0010.

5
6 **Q. What is the purpose of the testimony you are presenting?**

7 A. The purpose of my testimony is to address the transfer of assets of Willow Valley Water
8 Co. Inc. ("Willow Valley") to EPCOR Water Arizona Inc. ("EWAZ") (collectively, the
9 "Applicants"). Specifically, I have been asked by RUCO to address issues concerning the
10 impact of such a transfer on the Accumulated Deferred Income Tax ("ADIT") balances of
11 the water utility, and related concerns about income tax normalization. Based on my
12 experience in dealing with similar issues in other cases involving transfer of ownership of
13 utilities and rate case treatments, as well as with regulated public utility income tax issues,
14 I will also address options available to the Commission for dealing with these issues in the
15 current case, and will present my recommendations.

16
17 **Q. What information did you review in conducting your analysis?**

18 A. I reviewed the Joint Application and direct testimony of Willow Valley and EPCOR,
19 direct testimony of Staff and RUCO (focusing on the ADIT-related issues), and the
20 rebuttal testimony of Willow Valley and EPCOR as well as selected responses to data
21 requests, and public information. I also reviewed information contained Larkin &
22 Associates' files for other cases in which similar issues were investigated.

23
24 **Q. Have you prepared any attachments to be filed with your testimony?**

1 A. Yes. Attachments RCS-1 through RCS-10 contain additional background and
2 qualifications information and copies of selected documents that are referenced in my
3 testimony.

4
5 **Q. Please briefly explain what is included in each of those attachments.**

6 A. Attachment RCS-1 contains additional information on my Background and Qualifications.

7 Attachment RCS-2 contains Staff responses to Willow Valley Data Request Set 1.

8 Attachment RCS-3 contains Private Letter Ruling 9447009, dated November 25,
9 1994.

10 Attachment RCS-4 contains Private Letter Ruling 9418004, dated January 14,
11 1994.

12 Attachment RCS-5 contains Dominion Peoples/SteelRiver, Joint Petition for
13 Approval of Settlement in Pennsylvania PUC Docket No. A-2008-2063737, dated
14 September 4, 2009.

15 Attachment RCS-6 contains excerpts of T.W. Phillips Gas and Oil Co./SteelRiver,
16 Joint Petition for Approval of Settlement in Pennsylvania PUC Docket No. A-2010-
17 2210326, dated April 15, 2015.

18 Attachment RCS-7 Dominion Hope/Peoples Hope Gas Companies, LLC, West
19 Virginia PSC Order in Case No. 08-1761-G-PC, dated December 22, 2009.

20 Attachment RCS-8 contains Excerpts on the ADIT Issue from Connecticut Public
21 Utilities Regulatory Authority's January 22, 2014 Decision in Docket No. 13-06-08,
22 Application of Connecticut Natural Gas Corporation to Increase Its Rates and Charges.

23 Attachment RCS-9 contains Iberdrola-UIL/OCC settlement in Connecticut PURA
24 Docket 15-07-38 containing resolution of previously noted loss of utility ADIT concerns.

25 Attachment RCS-10 contains Connecticut Public Utilities Regulatory Authority
26 May 9, 2014 letter to Connecticut Natural Gas Corp. in Connecticut PURA Docket about

1 the need for the Private Letter Ruling request to be even-handed, neutral, fair, open and
2 transparent on the applicability of the Depreciation Normalization rules contained in 26
3 U.S. Code § 168(i)(9) and Treas. Reg. §1.167(l)-1, to the ADIT issue raised in that
4 proceeding.

5
6 **II. BACKGROUND**

7 **Q. What Arizona utilities are involved in the proposed transaction?**

8 A. Willow Valley Water Co., Inc. is requesting authority to sell its assets and transfer its
9 certificate of convenience and necessity ("CCN") to EWAZ.

10
11 **Q. Please briefly describe Willow Valley Water Co., Inc.**

12 A. Willow Valley is a public service corporation in Arizona, authorized for the provision of
13 water utility service in a portion of Mohave County under a CC&N granted in
14 Commission - Decision Nos. 32436, 34869, 55434, 68610. Willow Valley serves
15 approximately 1,620 connections in its approximately 3.5 square miles existing service
16 area. Its current water system consists of 10 wells, with a total capacity of 1,765 gallons
17 per minute; 4 storage tanks, with a combined capacity of 502,000 gallons; 12 booster
18 pump stations; and associated distribution systems. Willow Valley's parent, Global Water
19 Resources, Inc. ("Global") is well capitalized and has access to the financial markets.
20 Global is a water resource management company based in Phoenix that owns and operates
21 regulated water, wastewater and recycled water utilities. The stock of Global's parent,
22 GWR Global Water Resources Corp., is traded on the Toronto stock exchange and it
23 reported total assets of approximately \$307.6 million and had annual revenue of
24 approximately \$33 million in 2013 and 2014.

25
26 **Q. Please briefly describe EWAZ.**

1 A. EWAZ is a public service corporation, authorized to provide water service to nine districts
2 in Arizona, among of which are the Mohave and North Mohave Water Districts. These
3 two districts are located ten miles north of Willow Valley's certificated service area.
4 EWAZ serves approximately 128,000 water customers in Arizona, including
5 approximately 16,000 in its Mohave Water District and 2,000 in its North Mohave Water
6 District. EWAZ is a subsidiary of EPCOR. EPCOR is headquartered in Edmonton,
7 Alberta, Canada. The sole shareholder of EPCOR is the City of Edmonton, Canada.
8 EPCOR has two key business lines: (1) water and (2) wires, and serves primarily in three
9 regions: (1) the Edmonton region, (2) Alberta's oil sands and (3) the Southwestern U.S.
10 EWAZ is part of EPCOR's water and wastewater business in the Southwestern U.S.
11 region. In this region, EPCOR's regulated water utilities are located in Arizona and New
12 Mexico and include Chaparral City Water Company, EPCOR Water Arizona (aka
13 "EWAZ"), and EPCOR Water New Mexico. Those Southwestern U.S. EPCOR utilities
14 provide water and wastewater services to approximately 195,000 customer connections
15 across 22 communities. For 2013, EPCOR had:

- 16 • Consolidated Revenue of C\$1.955 billion, of which approximately
- 17 27 percent is related to its water services;
- 18 • Consolidated Operating Income of C\$290 million, of which
- 19 approximately 40 percent is related to its water services;
- 20 • Consolidated Total Assets of C\$5.447 billion, of which
- 21 approximately 48 percent is related to its water services; and
- 22 • Consolidated Earnings before Interest, Taxes, Depreciation, and
- 23 Amortization (EBITDA) of C\$435 million, of which approximately
- 24 40 percent is related to its water services.

25
26 **Q. What are some of the reasons cited by Applicants for their proposed transaction?**

27 A. Willow Valley is a Class C water utility that is located close to EWAZ's Mohave Water
28 District. Global had indicated that it is seeking to focus on its main service area in
29 Maricopa and Pinal Counties and on its core business strategy of providing regionally

1 integrated water and wastewater service, and has decided to divest Willow Valley's two
2 potable water systems in Mohave County.

3 EWAZ has agreed to buy all of Willow Valley's assets necessary for the operation
4 of Willow Valley's utility systems, which includes its water systems; associated real
5 property; and the permits, certificates, and other approvals that grant Willow Valley the
6 authority to operate its system, including its CC&N. Also, all customer meter deposits,
7 developer deposits, and prepayments under any line extension agreements held by Willow
8 Valley will be transferred to EWAZ as part of the Transaction. EWAZ will assume the
9 refunding obligations, if any, for these deposits and prepayments. Willow Valley will
10 retain all customer security deposits, apply any deposits to its last bill to customers, and
11 refund any difference.

12 EWAZ plans to pay the full purchase price, which includes a component of
13 compensation for the going concern value of the Willow Valley systems. EWAZ
14 proposes a mechanism to recovery from Willow Valley ratepayers the acquisition
15 premium (amount that it would be paying in excess of existing rate base). The
16 Transaction is not expected to affect any other utility. Because the proposed transaction is
17 structured as an asset sale, one result of the transaction, if approved, would be to
18 extinguish the existing Accumulated Deferred Income Taxes ("ADIT") on Willow
19 Valley's books, which are currently providing a significant source of non-investor supplied
20 cost-free capital supporting the water utility's rate base. Extinguishment of exiting utility
21 ADIT is one factor that presents a source of harm to ratepayers since, other things being
22 equal, the rate base would be significantly higher post-transaction and the rate base
23 increase due to the extinguishment of existing ADIT is attributable to the ownership
24 transfer and how it is being structured.
25

III. CONCERNS REGARDING THE PROPOSED TRANSACTION AND THE WAY IT IS STRUCTURED, WHICH WILL EXTINGUISH THE EXISTING ADIT BALANCES OF THE WATER UTILITY.

Q. What is ADIT?

A. ADIT is a source of non-investor supplied, zero-cost capital that is used for ratemaking purposes as an offset to rate base. ADIT related to tax and book depreciation timing differences results from the utility recording Deferred Income Tax on its books. A simplified accounting example of the impact of tax depreciation exceeding book depreciation is provided below. This illustrative example assumes that tax depreciation exceeds book depreciation in the year by \$10 million and that the Company is paying Federal income taxes at a 35% tax rate.

	<u>DR.</u>	<u>CR.</u>
Federal Income Taxes Payable	\$3,500,000	
Current Income Tax Expense		\$3,500,000
To record the reduction to current Federal income taxes from the use of accelerated tax depreciation		
Deferred Federal Income Taxes	\$3,500,000	
Accumulated Deferred Income Taxes		\$3,500,000
To record the increase in Deferred Income Taxes resulting from normalizing the difference between book and tax depreciation ofr Federal income taxes.		

The decrease to Current Income Taxes Expense of \$3.5 million is offset by the increase of Deferred Income Tax Expense. The ADIT of \$3.5 million becomes cost-free capital that is provided by ratepayers through that payment of the utility's revenue requirement, which includes Deferred Income Tax Expense. The ADIT also has similarities to a zero cost loan from the government in the form of deferred income tax payments in that the company can use the tax savings it realized by the deductions for accelerated tax depreciation interest-free until some point in the future, typically when the asset is retired or sold.

1

2 **Q. How is ADIT typically treated for ratemaking purposes?**

3 A. ADIT represents a source of cost-free capital to the utility. For utility ratemaking
4 purposes, the ADIT is typically reflected as a deduction to utility rate base, to reflect that
5 this is a source of non-investor-supplied cost-free capital. Because ADIT for liberalized
6 depreciation is a rate base offset, the decreased amount of ADIT equates to an increased
7 rate base.

8

9 **Q. How would the utility's existing ADIT amounts be affected by the transfer of**
10 **ownership, and the way it is structured?**

11 A. Because the proposed transaction is structured as an asset sale, the existing ADIT on
12 Willow Valley's books would be extinguished. Put another way, the proposed transaction
13 would result in eliminating Willow Valley's ADIT balance. Basically, the interest-free
14 loan that has been provided to Willow Valley through ratepayer funding of the utility's
15 deferred tax expense would disappear. This would occur because the seller would need to
16 pay the income tax liability that would be triggered by the sale of assets (for income tax
17 purposes) to the new owners.

18

19 **Q. Is the extinguishment of existing utility ADIT a major source for concern with this**
20 **proposed transaction and how it is structured?**

21 A. Yes. Other things being equal, the extinguishment of existing ADIT would contribute to
22 Willow Valley having a significantly higher rate base, post-transaction. Thus, the
23 extinguishment of existing ADIT is one aspect of the proposed transaction that presents a
24 source of harm to ratepayers, if not remedied.

25

26 **Q. Have you encountered this type of issue in other proceedings?**

1 A. Yes. The extinguishment of existing ADIT can arise from transfer of ownership
2 transactions, including transactions that are structured as a sale of utility assets, as is the
3 case with the Applicants' proposed transaction. Extinguishment of existing utility ADIT
4 can also occur when a proposed transaction is structured as a stock sale, when a special
5 income tax election is made (pursuant to Internal Revenue Code §338(h)(10)) to treat the
6 stock transfer as an asset sale for federal income tax purposes. This situation of ADIT
7 extinguishment can thus present itself in the context of a transfer of ownership proceeding
8 when either type of transaction exists. For the proposed transaction involving Willow
9 Valley, the existing utility ADIT would be extinguished because the Applicants have
10 proposed to structure the utility change-in-control transaction as an asset sale.

11
12 **Q. If the extinguishment of existing utility ADIT balances are disclosed during a**
13 **proposed utility acquisition or ownership transfer, what concerns does that raise?**

14 A. If the extinguishment of existing utility ADIT balances are disclosed during a proposed
15 utility acquisition or ownership transfer, concerns are typically raised regarding whether
16 the proposed transfer will have detrimental consequences to ratepayers because of the loss
17 of the ADIT that had been accumulated, and the impact on utility rate base. As noted
18 above, structuring the change of control transaction as an asset purchase for federal
19 income tax purposes results in eliminating the existing ADIT balance that had built up on
20 the utility's books, which functions as a substantial rate base deduction.

21
22 **Q. How can utility ratepayers be protected against the harmful impacts of such a**
23 **transaction?**

24 A. In order to protect ratepayers from the rate base increase related to this detrimental aspect
25 caused by the change in ownership and the way the ownership change is being structured,
26 the requested transaction could be denied if the harm cannot be adequately remedied.

1 Alternatively, a hold harmless provision or some other type of condition that will protect
2 ratepayers from the detrimental impact of the substantial rate base increases caused by the
3 ownership change and the way it is structured should be required among the conditions for
4 approval.

5
6 **Q. What happens to the ADIT balances in the period after the ownership transfer?**

7 A. The proposed ownership transfer, as noted above, would result in setting the utility's
8 existing ADIT balances to zero. After the transfer, the new owner will typically reflect a
9 tax basis in the acquired assets based on the fair value of the assets as of the transfer date,
10 and will begin accruing tax depreciation from that date forward, using the new tax basis.
11 This process of recording deferred income tax expense and crediting the ADIT account for
12 book-tax differences, such as for accelerated tax depreciation, then starts the process of
13 rebuilding the ADIT balance from the ownership transfer date forward.

14
15 **Q. What did Staff and RUCO recommend in order to protect ratepayers from the**
16 **extinguishment of existing utility ADIT as a result of the proposed transaction?**

17 A. Staff and RUCO recommended a hold harmless provision that would essentially maintain
18 the same level of rate base offset that existed prior to the ownership transfer on a post-
19 ownership transfer basis. Staff's proposal, for example, involved reclassifying the ADIT
20 balance as a Regulatory Liability. RUCO made a similar proposal: to require the use of a
21 Regulatory Liability to protect ratepayers. Another way to view these Staff and RUCO
22 recommendations would be as a condition for approval of the proposed transaction that
23 Applicants accept and agree to a requirement to establish a Regulatory Liability which
24 will be used as a rate base offset in future rate cases.

25

1 **Q. Is requiring a condition for approval of the proposed transaction that Applicants'**
2 **accept and agree to a requirement to establish a Regulatory Liability which will be**
3 **used as a rate base offset in future rate cases, the same as transferring an ADIT**
4 **balance from one owner to another?**

5 **A. No.** Transferring an ADIT balance in a change-of-control transaction that is being
6 structured as an asset transfer would not occur. The ADIT balance would be extinguished.

7 Requiring Applicants to accept and agree to a requirement to establish a
8 Regulatory Liability or some alternative method of protecting ratepayers, which will be
9 used as a rate base offset in future rate cases, is not the same thing. It presents these
10 choices to the Applicants: (1) accept the requirement to establish the Regulatory Liability
11 as one of the conditions that are being required to obtain approval of the change-of-control
12 transaction, or (2) withdraw the proposed transaction and re-submit it with a structure that
13 does not involve extinguishment of existing utility ADIT, or (3) have the proposed
14 transaction rejected since a significant source of ratepayer harm (increased rate base cause
15 by the transaction and how it is structured) has not been remedied sufficiently for the
16 transaction to be in the public interest.

17
18 **Q. What has EWAZ stated about the ADIT and Regulatory Liability issue in its**
19 **rebuttal testimony?**

20 **A.** The rebuttal testimony of EWAZ witness Sarah Mahler addresses this issue at pages 10-11
21 of 14. EWAZ opposes the creation of a Regulatory Liability on Willow Valley's books.
22 Reasons for opposition stated include EWAZ's opinion that this would have a negative
23 impact on the consolidation of small water systems in Arizona, and uncertainty about the
24 ability to close the transaction if the ADIT-associated Regulatory Liability requirement is
25 included in the final order.
26

1 **Q. Does she offer an alternative?**

2 A. At page 11, Ms. Mahler states that, if Staff's recommendation is adopted, EWAZ
3 recommends that the amortization of the Regulatory Liability commence immediately
4 upon transfer, based on a seven-year amortization period, i.e., a rate of 14.3 percent per
5 year, which she indicates would produce amortization of \$37,175 per year, based on
6 Global's net ADIT balance decline from \$367,598 to \$260,224 between December 31,
7 2011 and December 31, 2014.

8
9 **Q. What has Willow Valley stated in its rebuttal about the ADIT and Regulatory**
10 **Liability issue?**

11 A. Willow Valley/Global witness Ron Fleming states as follows on page 3 of his rebuttal
12 testimony:

13 Q. What aspect of their [Staff and RUCO] testimony concerns you most?

14 A. Their proposal to create a regulatory liability for EWAZ in the amount
15 of \$260,224 as an offset to EWAZ's rate base. This is very significant in
16 the context of Willow Valley's rate base of approximately \$2.2 million, as
17 contemplated in the Asset Purchase Agreement. An 11% reduction to rate
18 base is significant; when also considering the fact that the ADIT liability
19 must still be accounted for by Global in future tax filings. This is akin to a
20 double accounting. If other companies face this issue of a significant cut to
21 rate base due simply to an asset sale, it will become very difficult to
22 financially justify pursuing any such deals. Mr. Walker will explain why
23 this proposed regulatory liability should be rejected.

24 Willow Valley's other rebuttal witness, Paul Walker, asserts that the Regulatory
25 Liability is poor regulatory policy and "will not only end this transaction, it will establish a
26 phenomenally high level of regulatory uncertainty that will make consolidating Arizona's
27 water utility impossible."¹ He claims further that the Staff and RUCO recommendation is
28 unprecedented.² He is apparently not aware of any case where a Regulatory Liability has

¹ Rebuttal Testimony of Paul Walker on Behalf of Willow Valley Water Co., Inc. ("Walker Rebuttal") at page 4.

² Id.

1 been created.³ After stating that he is not an attorney nor a tax accountant and that he is
2 "not opining on the tax consequences raised by the forced transfer of ADIT from one
3 owner to another" and apparently based on his reliance upon a Nebraska utility's witness
4 who is not filing testimony in the current proceeding, Mr. Walker implies or asserts that
5 the ADIT issue would violate IRS tax normalization rules.⁴
6

7 **Q. Willow Valley/Global witness Fleming, at page 3 of his rebuttal testimony, asserts**
8 **that having \$260,224 as an offset to EWAZ's rate base would be a significant**
9 **reduction of approximately 11 percent to Willow Valley's rate base of approximately**
10 **\$2.2 million, as contemplated in the Asset Purchase Agreement. Willow Valley**
11 **rebuttal witness Walker, at page 5, states that: "As Mr. Fleming explains, the**
12 **regulatory liability will significantly reduce rate base. And if rate base is reduced**
13 **each time a utility is sold, there will be significant disincentive for acquisitions of**
14 **water utilities." Is that the only way to look at the impact of the proposed**
15 **transaction?**

16 **A. No. These Willow Valley/Global witnesses seem to have it backward. Rate base would**
17 **not be reduced as a result of their proposed transaction; it would be increased due to the**
18 **extinguishment of the existing Willow Valley ADIT, which provides a source of non-**
19 **investor-supplied cost-free capital that is currently supporting some of the Willow Valley**
20 **rate base. That ADIT balance has already accumulated on Willow Valley's books and**
21 **currently represents a rate base offset. But for the proposed ownership transfer (and how**
22 **it is being structured), that existing ADIT would continue to be used as an offset to**
23 **Willow Valley rate base. In contrast, the extinguishment of that existing ADIT would**
24 **result in a significant increase in the Willow Valley rate base, which would be occurring**

³ Id, at 5, lines 23-24.

⁴ Id at page 6. He attaches a copy of Nebraska testimony from Mr. Lovinger as Attachment Walker-1.

1 solely due to the proposed ownership transfer, and how it is being structured as an asset
2 sale.

3
4 **Q. Would the Regulatory Liability reduce Willow Valley's pre-transfer rate base?**

5 A. No. The idea of the Regulatory Liability is simply to prevent, or remedy, the significant
6 rate base increase that would occur solely as the result of the change-of-ownership
7 transaction and how that proposed transaction is structured. The Regulatory Liability
8 would essentially keep the rate base at the same level it was prior to the ownership change.
9 Viewed from the perspective of before-and-after the ownership change, the Regulatory
10 Liability does not reduce the pre-transaction Willow Valley rate base, it simply prevents it
11 from increasing substantially due to the proposed ownership change and how the
12 transaction is being structured.

13
14 **Q. Is extinguishment of existing utility ADIT balances due to how ownership transfer**
15 **transactions are structured something that you believe should be encouraged by**
16 **utility regulators, including this Commission?**

17 A. No. Existing utility ADIT should be preserved by regulatory authorities, including this
18 Commission, in utility ownership transfers whenever possible. For most utilities, ADIT
19 represents a significant source of non-investor-supplied cost-free capital that supports the
20 investment in utility rate base and which helps hold down rate increases. This appears to
21 be the situation for Willow Valley as well, where the impact of ADIT could be as much as
22 11 percent (or more) of rate base. Whenever utilities are being transferred and the transfer
23 can be accomplished by using a structure that does not extinguish the existing utility
24 ADIT, structuring the ownership transfer in a manner to preserve existing utility ADIT
25 should be encouraged. In contrast, transferring utilities between well-capitalized owners
26 in transactions that are structured to extinguish existing utility ADIT is something that

1 should be discouraged. Extinguishment of existing utility ADIT from ownership transfers
2 should be discouraged, particularly if there are other ways of achieving an ownership
3 transfer that would preserve the utility ADIT.

4
5 **Q. Some concerns have been raised about tax normalization requirements. Will you**
6 **please address those concerns, and advise the Commission based on your experience**
7 **of similar issues have been handled in other utility ownership transfer situations?**

8 **A. Yes.** In the Fortis acquisition of UniSource Energy Corporation (and its utility
9 subsidiaries, Tucson Electric Power, UNS Electric and UNS Gas), Docket Nos. E-
10 04230A-14-0011 and E-01933A-14-0011, the potential harm to ratepayers from
11 extinguishment of utility ADIT was addressed by assuring that the transaction was being
12 structured in a manner (as a stock purchase) such that existing utility ADIT was not being
13 extinguished.⁵ Assurance that there would be no potential harm to ratepayers from
14 extinguishment of utility ADIT was also similarly addressed in other recent high profile
15 utility industry mergers, including Exelon-PHI and Iberdrola-United Illuminating. Based
16 on my regulatory experience, it is generally preferable to avoid having the utility ADIT
17 extinguished due to the structure of the change-in-control transactions, rather than
18 allowing a proposed transaction to be consummated that is structured in a manner to
19 extinguish utility ADIT, and having to develop remedies to alleviate the harm to rate
20 payers from the higher rate base that exists post-acquisition due to the ADIT
21 extinguishment. One of the difficulties in crafting remedies to protect ratepayers from
22 change-in-control transactions that are structured in a manner to result in extinguishing

⁵ That transaction was structured as a stock purchase and it was confirmed in discovery that no Internal Revenue Code §338(h)(10) election (to treat the transfer as an asset sale for federal income tax purposes) would be made in conjunction with that transaction. See, e.g., Applicants' response to RUCO UNS 1.02 reproduced in Attachment RCS-5, page 40 of 88 in my prefiled direct testimony on behalf of RUCO in Docket Nos. E-04230A-14-0011 and E-01933A-14-0011.

1 existing utility ADIT is doing so without implicating concerns regarding tax normalization
2 requirements.

3
4 **Q. Has Staff responded to a discovery request that asked about the tax normalization**
5 **concern?**

6 A. Yes. Staff's Responses to Willow Valley Water Co., Inc.'s First Set of Data Requests to
7 Staff include some material that relates to the ADIT issue. Staff's response to Willow 1.8
8 states that:

9 Staff has determined that its recommendation to create a regulatory
10 liability to replace the ADIT balance may result in a violation of the
11 IRS normalization rules and therefore withdrawal of this
12 recommendation is under internal review.

13
14 Additionally, a portion of Staff's response to Willow 1.1 (work papers) poses the
15 following questions:

16 May the buyer reduce its rate base by the seller's pre-disposition deferred
17 tax liability (DTL)

18 - By an amount that happens to equal the seller's DTL?

19 - May buyer reduces [sic] its revenue requirement by an amount that
20 approximates the effect of the seller's pre-acquisition DTL on its return?

21 That Staff response also contains handwritten "no" responses to the two questions.

22 The Staff response also includes a copy of Private Letter Ruling ("PLR") 143241-14 dated
23 July 6, 2015.⁶

24
25 **Q. Are you convinced by that Staff data request response that the correct answers to**
26 **those two queries are unequivocally "no"?**

⁶ A copy of those Staff responses is included in Attachment RCS-2.

1 A. No. I believe the correct answers may be more nuanced, and may be dependent on the
2 specific facts involved in each unique situation. Provisions that are accepted in a
3 stipulation as conditions imposed on a change-in-control transaction can, and have been
4 crafted in various ways to achieve ratepayer protection without necessarily subjecting the
5 utility to normalization violations that would prevent the utilities' use of accelerated tax
6 depreciation. Having said that, it is usually much easier for regulators to reject proposed
7 change in control transactions that extinguish utility ADIT than to craft adequate remedies
8 that are immune to normalization concerns.

9
10 **Q. Do you agree with Staff and Applicants that some concerns about tax normalization**
11 **requirements have been raised that may require resolution in order to avoid harm to**
12 **ratepayers?**

13 A. Yes.

14
15 **Q. Should the Commission require a thorough vetting of the normalization concerns?**

16 A. That depends. If the Commission were inclined to approve the proposed transaction as
17 presently structured, and were inclined to utilize the Regulatory Liability approach to
18 remedying the extinguishment of utility ADIT, then the normalization concerns would
19 probably need to be fully vetted prior to approval of the transaction.

20 If the Commission is inclined to reject the proposed transaction for reasons that
21 could include because of how it has been structured to result in extinguishing existing
22 Willow Valley water utility ADIT, then there would be no need to thoroughly vet
23 normalization concerns or to require a private letter ruling to be obtained.
24

1 **Q. Would rejection of Applicants' proposed transaction because of how it was**
2 **structured prevent Applicants from re-thinking, re-structuring, or re-presenting**
3 **their proposed ownership transfer of Willow Valley?**

4 A. Probably not. Rejection of the transaction as presently structured presumably would not
5 preclude Applicants from restructuring their proposed change-in-control transaction in
6 another form that would not entail extinguishment of existing utility ADIT balances, or
7 from subsequently requesting Commission approval of a revised transaction that is
8 structured to preserve existing ADIT balances.

9
10 **Q. Is requiring a private letter ruling from the IRS one way of having normalization**
11 **concerns vetted?**

12 A. Yes. By requiring the Applicants to obtain a private letter ruling based specifically on the
13 fact situation presented in this proceeding, and ideally requiring that before transaction
14 approval, that would be one way in which the normalization concerns that have been
15 raised could be thoroughly vetted. Since ratepayers are not causing Applicants to propose
16 structuring their change-of-ownership transaction in a form that would result in
17 extinguishing existing utility ADIT, if the PLR route is used, the cost of preparing and
18 obtaining the PLR should be borne by Applicants and not charged to Willow Valley
19 ratepayers. Additionally, to assure that the PLR request is factually accurate and
20 presented in a balanced manner, the Staff and RUCO should have input to its drafting
21 before it is submitted to the IRS.

22
23 **Q. You mentioned that a PLR was included with Staff's response to an EWAZ data**
24 **request. Does that PLR 143241-14 appear to be based on Willow Valley's situation?**

25 A. No, it does not. That PLR contains the following description, which does not appear to be
26 based on Willow Valley's situation:

1 Taxpayer, a wholly-owned subsidiary of Parent, is primarily engaged in the
2 business of generating, transmitting, distributing, and selling electric power
3 to customers in State A and State B. It is subject to regulation by
4 Commission A, Commission B, and Commission C with respect to terms
5 and conditions of services, including the rates it may charge for its services.
6 All three Commissions establish Taxpayer's rates based on Taxpayer's
7 costs, including a provision for a return on the capital employed by
8 Taxpayer in its regulated business.

9 The law of State A provides a process under which a utility may recover its
10 costs relating to projects such as new electric generation facilities as a
11 stand-alone rate adjustment added to customers' base rates. As relevant to
12 this ruling request, the process for setting the rates involves two
13 components. First, a taxpayer files estimated projections of all factors,
14 including Accumulated Deferred Federal Income Taxes (ADFIT), relevant
15 to the costs associated with the facility that is the subject of the rate
16 adjustment. Rate base for this purpose is calculated using an average of the
17 thirteen projected end of month balances of the components of rate base.
18 The rate adjustment computed using these projections goes into effect at
19 the beginning of the test period. The test period is a twelve month period.
20 The anticipated collections from rate payers, the actual cost incurred with
21 respect to the generating facility and any differences between anticipated
22 amounts and actual amounts are reconciled by a "true-up" mechanism at
23 the end of the test year. Under this mechanism, the reconciliation amount is
24 either charged to ratepayers (if actual revenues are below estimates) or
25 credited to ratepayers (if actual revenues exceed estimates) as part of the
26 rates established for the forthcoming rate year. For both under and over
27 collections, a carrying charge is imposed.

28 Taxpayer owns and operates electric transmission lines in several states,
29 including State A and State B. These lines are integrated into Operator, a
30 regional transmission operator. The rates that Taxpayer may charge its
31 customers for these transmission services are set using a formula approved
32 by Commission C. The formula rates are calculated using a methodology
33 similar to that used to calculate the rate adjustments, inasmuch as the
34 formula rates are calculated using projected costs to establish rates during
35 the period for which rates are being set and a true-up based on over or
36 under recoveries that are reflected in a subsequent rate year. The rates are
37 determined by application of the formula approved by Commission C and
38 go into effect with no additional action by Commission C.

39 This PLR is clearly not for Willow Valley. Moreover, the specific tax issues
40 addressed in that PLR are not particularly on point with the ADIT issue in the current
41 Willow Valley transfer-of-ownership proceeding. The PLR does not appear to even

1 address the specific issue of using a Regulatory Liability that has been ordered by a
2 regulatory commission as a condition to approval of a change-of-control transaction. I
3 also note that the PLR indicates that it is directed only to the taxpayer who requested it
4 and may not be used or cited as precedent⁷:

5 This ruling is directed only to the taxpayer who requested it. Section
6 6110(k)(3) of the Code provides it may not be used or cited as precedent.

7 That particular PLR does not appear to address the specific normalization concerns that
8 have been raised in the current Willow Valley transfer-of-ownership proceeding. As such,
9 any reliance upon it for issues in the current proceeding would appear to be misplaced.
10

11 **Q. Are you familiar with some other Private Letter Rulings that appear to be a bit**
12 **closer on point to the Willow Valley issue being addressed in the current case?**

13 **A.** Yes, without attempting be exhaustive due to the short time frame for preparing
14 surrebuttal since being contacted by RUCO, I will note that one of the issues addressed in
15 PLR 9447009 (11/25/1994)⁸ concerned the application of Internal Revenue Code ("IRC"
16 or "Code") Section 168(i)(10) after a corporation acquired for cash all of the outstanding
17 stock of a regulated public utility that owned and operated a natural gas pipeline in several
18 states. Elections were made under Section 338 of the Code, and the purchase of the
19 utility's stock was treated as a purchase of its assets for federal income tax purposes. In
20 that PLR, the IRS ruled that, for any period after the date of its acquisition, the utility will
21 violate the normalization requirements of Section 168(i)(9) if its rate base is reduced for
22 the unamortized ADFIT attributable to accelerated depreciation on public utility property
23 claimed before the acquisition date. The IRS reasoned that the utility's deferred tax

⁷ This is standard language that the IRS is required to include in all Private Letter Rulings. Tax practitioners can nevertheless gain useful insights for how the IRS would rule on specific tax issues in situations where the fact situation of the PLR is highly similar to a particular taxpayer's facts and circumstances.

⁸ This PLR is attached to my surrebuttal testimony as Attachment RCS-3.

1 reserve resulting from accelerated depreciation ceases to exist. Accordingly, the IRS said
2 that the deferred tax reserve resulting from accelerated depreciation should be removed
3 from the utility's books of account and not flowed through to its customers.

4 In PLR 9418004 (1/14/1994)⁹, one of the issues addressed was for a public utility
5 company providing telecommunications services through local exchange telephone
6 operations. The company acquired, subject to a Section 338(h) election, all of the stock of
7 an unrelated public utility company ("Sub"). Before the acquisition, Sub claimed
8 investment credits and accelerated depreciation deductions on its public utility property.
9 The IRS ruled that the Sub will violate the normalization rules of Section 168(i) if its rate
10 base is reduced for unamortized ADIT attributable to accelerated depreciation on property
11 claimed before the acquisition date.

12
13 **Q. You mentioned that those PLRs were a bit closer on point with the issues being**
14 **addressed in Willow Valley. Do you consider those to be exactly on-point with the**
15 **Willow Valley issue and thus provide a definitive conclusion?**

16 **A.** No. I view those PLRs as being sufficient to establish that there could be a normalization
17 concern. However, they address a different fact situation than the one presented in the
18 current docket. Neither addresses the use of a Regulatory Liability that is established by a
19 utility regulatory commission as a condition to approval of a proposed change-in-control
20 transaction.

21
22 **Q. In your experience, is the Regulatory Asset approach that was recommended in**
23 **direct testimony by Staff and RUCO unprecedented?**

24 **A.** No. The Regulatory Asset approach is one way that has been established in transfer-of-
25 control proceedings to try to protect utility ratepayers from a detrimental aspect of such

⁹ This PLR is attached to my surrebuttal testimony as Attachment RCS-4.

1 transactions, specifically from the harm related to the higher rate base caused by the loss
2 of the non-investor supplied cost-free capital in the form of ADIT, that would occur only
3 due to the change-of-ownership transaction and how it was structured.
4

5 **Q. Are other utilities using that approach?**

6 A. Yes. I am aware of two non-Arizona utilities that are using a similar approach that
7 involves protecting ratepayers from increased rate base that resulted from extinguishment
8 of ADIT in a change-of-control transaction.
9

10 **Q. Were those utilities cited for a normalization violation?**

11 A. No. To my knowledge, those utilities have continued to reflect the post-ownership-change
12 rate base treatment and have not been cited for tax normalization violations.¹⁰
13

14 **Q. Is that the approach that you would typically recommend to protect ratepayers from
15 the loss of ADIT in a proposed ownership-transfer transaction?**

16 A. No. I acknowledge that there can be concerns about whether a particular approach may
17 create a normalization violation. An approach that uses a Regulatory Liability amount
18 that equals or approximates the previous owner's ADIT balance that was extinguished due
19 to the transfer of ownership may be a legitimate cause for concerns regarding tax
20 normalization requirements.
21

22 **Q. Are there other ways of protecting ratepayers from extinguishment of utility ADIT
23 that do not entail such tax normalization requirement related concerns?**

¹⁰ This is not intended to imply that the IRS agrees or disagrees with such treatment. I was not specifically involved in those regulatory proceedings which established the treatment and am not aware if those utilities have been subjected to IRS audits or if the IRS has reviewed the specific ratemaking treatments they have been using.

1 A. Yes. One way is to require the applicants to structure their change-of-ownership
2 transaction in a manner that does not result in extinguishing the ADIT of the utility that is
3 being transferred. One way of accomplishing an ownership transfer in a manner that does
4 not extinguish the utility's existing ADIT is to structure the ownership change as a stock
5 transfer, rather than an asset sale, for tax purposes. Willow Valley Water Co., Inc. appears
6 to be organized as a corporation, with its parent, Global, owning the stock. If the
7 Commission were to reject the proposed transaction, due to the way it has been structured
8 (as an asset sale and transfer of CCN), that could open an opportunity for the Applicants to
9 re-think the structure of their proposed transaction. A subsequently filed application
10 proposing to accomplish the ownership change via a transfer of stock (without a Code
11 §338(h)(10) election) could presumably structure the change-of-ownership in a manner
12 that would maintain the existing Willow Valley ADIT, i.e., that would eliminate the
13 ratepayer harm associated with extinguishment of utility ADIT, that has raised major
14 concerns about the currently-proposed transaction.

15
16 **Q. Is requiring the Applicants, or the acquirer, to obtain a private letter ruling, another**
17 **way to address normalization concerns?**

18 A. Yes. Another way of addressing the concern and assuring that the transaction would not
19 create a normalization violation would be to require the applicant to obtain (preferably at
20 its own expense) a Private Letter Ruling based on the specific facts and circumstances
21 involved. The drafting of the PLR request should be subject to review and comment by
22 the parties to assure that it is presented in a balance manner and includes all important and
23 relevant facts. Ideally, an on-point ruling should be obtained and presented to the
24 regulatory commission before the transaction is approved.

25

1 **Q. Are there other ways of which you are aware, for addressing and remediating the**
2 **impact on utility ratepayers from change-of-control transactions that affect utility**
3 **ADIT balances?**

4 A. Yes. Requiring a rate freeze for the acquired utility for a specified period as a condition to
5 change-in-control transaction approval does not create any concerns about income tax
6 normalization violations. Maintaining the acquired utility's existing rates for a sufficient
7 period, without increases, is thus one method of addressing and remediating an
8 extinguishment of utility ADIT situation.

9 Requiring a specified amount of ratepayer credits or a fund established by the
10 purchaser that will be used to offset future rate increases as a condition to approving a
11 proposed change-in-control transaction is another method.

12 Combining a rate moratorium/rate freeze provision with a purchaser-provided
13 ratepayer fund as conditions that are required to obtain approval of a proposed change-in-
14 control transaction has been employed in other cases. Such a combined requirement might
15 be appropriate in situations where having a rate freeze in effect long enough to fully
16 mitigate ratepayer harm might not be practical.

17

18 **Q. Have you been involved in ownership transfer proceedings in which such methods**
19 **were employed?**

20 A. Yes. One illustrative example involved the transfer of Peoples Gas from Dominion to
21 SteelRiver. Attachment RCS-5 presents the settlement agreement that was reached in that
22 proceeding and the Pennsylvania PUC's Order. As shown in Attachment RCS-5,
23 conditions to that change-in-control transaction included a rate moratorium and a
24 ratepayer fund to be utilized to offset future rate increases.

25

1 **Q. What types of calculations were utilized to negotiate the amount of ratepayer fund to**
2 **assure that utility ratepayers were being adequately protected from the**
3 **extinguishment of the pre-transfer ADIT?**

4 A. Calculations were made using two time-based projections of utility ADIT balances. One
5 stream examined ADIT balances that existed at the time preceding the ownership transfer
6 and that would have remained if no ownership transfer occurred. Another looked at ADIT
7 balances that would occur under the new ownership. Those ADIT balances started with
8 zero as of the date of the ownership transfer, and were related to the new ADIT that would
9 be generated by the utility under the new ownership. Typically, the tax basis to the new
10 owner is higher under an asset sale. At some point several years after the date of the
11 ownership transfer, the ADIT balances under the new ownership would eventually reach
12 the level of the ADIT balances without the ownership change. The two streams of ADIT
13 balances were compared, and differences were calculated each year. The ADIT
14 differences each year were converted into revenue requirement impacts, and the stream of
15 revenue requirement impacts was then evaluated using net present value ("NPV") analysis,
16 with a range of interest rates. The results of such calculations, particularly the NPV
17 analysis, was used to negotiate an amount of ratepayer provided funding that was deemed
18 sufficient to effectively hold harmless the impact of the ownership change on ratepayers.
19 The amount became part of the conditions that were imposed on the transaction as the
20 result of a negotiated settlement.

21
22 **Q. Were you able to make similar calculations for Willow Valley in the current case?**

23 A. No. In part because of the timing of when I was asked by RUCO to address the ADIT
24 issue, i.e., for surrebuttal rather than at the onset of the case, conducting thorough
25 discovery designed to obtain all of the necessary information to make similar calculations
26 for Willow Valley was not an option. Also, from the discovery responses to Staff and

1 RUCO data requests to Applicants that I reviewed, it did not appear that information on
2 projected ADIT balances, with and without the proposed ownership change, was available
3 in the discovery that had been asked prior to when I was contacted by RUCO.
4

5 **Q. Can you provide an illustrative example of how a combination of a rate freeze and**
6 **ratepayer credits were used to address protection for ratepayers to counteract the**
7 **adverse impact of extinguishing the utility's ADIT as a result of a change-in-control**
8 **proceeding?**

9 **A.** Yes. One illustrative example of the use of a combination of a rate freeze and ratepayer
10 credits to address protection for ratepayers of which I have knowledge is Docket No. A-
11 2010-2210326 before the Pennsylvania Public Utilities Commission in the *Joint*
12 *Application for All of the Authority and the Necessary Certificates of Public Convenience*
13 *to Transfer All of the Issued and Outstanding Shares of Capital Stock of T. W. Phillips*
14 *Gas and Oil Co., currently owned by TWP INC., to LDC Holdings II LLC, an indirect*
15 *subsidiary of SteelRiver Infrastructure Fund North America LP, and to Approve the*
16 *Resulting Change in Control of T. W. Phillips Gas and Oil Co.*
17

18 The settlement in that case included the following provisions for base rate credits
19 to customers and a rate moratorium¹¹:
20

21 1. T. W. Phillips will provide a rate credit in a future rate case under the
22 following terms and conditions.

23 (a) If the effective date of the first general base rate case increase following
24 the closing is within 5 years of the Closing Date, T. W. Phillips will
25 provide base rate credits to customers in the total amount of \$9 million.

26 (b) If the effective date of the first general base rate case following the
27 closing is more than 5 years and less than 10 years after the Closing Date,
28 T. W. Phillips will provide base rate credits to customers in the total
29 amount of \$4.5 million.

¹¹ See Attachment RCS-6.

1 (c) Any base rate credit provided for in subparagraphs a or b shall be used
2 to reduce the rates determined in the general rate proceeding and will be
3 allocated to the classes in proportion to the revenues approved in the rate
4 proceeding. Base rate credits shall not be applied to reduce the bills of
5 customers that receive discounted rates.

6 (d) Any base rate credit will be designed to provide the amounts allocated
7 to each class over not less than a 3 year period and will terminate upon
8 exhaustion of the amounts allocated to each class.

9 2. T. W. Phillips will not increase its existing base distribution rates prior to
10 December 1, 2013, unless there are substantial changes in regulation or
11 federal tax rates or policy. This paragraph shall not prohibit changes in
12 rates pursuant to the State Tax Adjustment Surcharge or the Universal
13 Service Program charge.

14
15 **Q. In that T.W. Phillips change-of-control transaction, what factor triggered the cause**
16 **for concern regarding the utility's ADIT balance and required the need for**
17 **mitigation of impacts on ratepayers to prevent harm?**

18 **A.** That particular transaction was structured as a stock sale; however, the applicants had
19 made a voluntary election under Section 338 of the Internal Revenue Code to treat the
20 transactions as an asset purchase for federal income tax purposes. The consequences of
21 making that election were to extinguish the selling utility's existing ADIT balances
22 effective with the date of the transaction. As noted above, the adverse impacts on utility
23 ratepayers that would have otherwise resulted were mitigated by a combination of rate
24 moratorium and specified base rate credit provisions that were required as conditions for
25 approval of the proposed transactions.

26
27 **Q. How were the specific amounts of base rate credits derived?**

28 **A.** The purchaser, SteelRiver, provided an updated Excel model in response to Consumer
29 Advocate discovery that included the impact of 2010 and 2011 bonus tax depreciation.
30 The difference in rate base under the "with" and "without" Section 338(h)(10) elections in
31 that updated model were used to project the rate base impacts of the change in ownership

1 and the Section 338(h)(10) election from 2012 through 2027, i.e., through the end of the
2 SteelRiver projected ownership period of T.W. Phillips. Calculations made in this
3 manner, and which also took into account the loss of investment tax credit ("ITC")
4 amortization that had been reducing T.W. Phillips' income tax expense, were made by me,
5 and were presented in a Highly Confidential Attachment to my testimony in that case.
6 Ultimately, those calculations were used to negotiate the specific amounts of base rate
7 credits that were contained in the settlement agreement reached in that case.
8

9 **Q. Have you attached a copy of selected public documents?**

10 A. Yes, related documents including the stipulated conditions for approval of that that TW
11 Phillips matter and the ratepayer protections that were utilized are attached in Attachment
12 RCS-6.
13

14 **Q. Without the mitigation of adverse impacts from extinguishment of utility ADIT in**
15 **that case, would that proposed transaction have been in the public interest?**

16 A. Probably not.
17

18 **Q. Have you also been involved in transfer-of-control proceedings in which no workable**
19 **solution to remedy the harm caused by the extinguishment of utility ADIT was**
20 **presented?**

21 A. Yes. Around the same time that Dominion was selling its Pennsylvania gas distribution
22 utility (Dominion Peoples Gas), Dominion was also trying to sell its West Virginia gas
23 distribution utility (Dominion Hope Gas). A copy of the West Virginia PSC's Order in the
24 Hope Gas ownership transfer case is presented in Attachment RCS-7. The West Virginia
25 PSC rejected that proposed transfer, citing as one reason for such rejection, the failure to

1 remedy the harm to ratepayers attributable to the extinguishment of the utility's ADIT and
2 the higher rate base approval of that ownership transfer would have entailed.

3
4 **Q. You had mentioned that one way to obtain clarity on the normalization issue was to**
5 **require applicants to request and obtain a Private Letter Ruling, and you**
6 **recommended that be obtained at Applicants' expense and prior to approval of the**
7 **proposed transaction. Please explain how that recommendation has evolved based**
8 **on your professional experience with this type of issue in other utility change-of-**
9 **control and rate case proceedings.**

10 **A.** In Connecticut Docket No. 10-07-09, *Joint Application of UIL Holdings Corporation and*
11 *Iberdrola USA, Inc. for Approval of a Change of Control of Connecticut Natural Gas*
12 *Corporation and The Southern Connecticut Gas Company*, the Connecticut Department of
13 Public Utility Control ("DPUC") addressed the proposed sale of Connecticut Natural Gas
14 Corporation ("CNG") and The Southern Connecticut Gas Company ("SCG") from
15 Iberdrola USA ("Iberdrola" or "IUSA") to UIL. Among other things, that sale involved an
16 election under Internal Revenue Code Section 338(h)(10) ("Section 338(h)(10) Election")
17 to treat the stock transfer as an asset sale for federal income tax purposes. In the Purchase
18 Agreement, UIL and Iberdrola "...agreed to cooperate to effect a tax election pursuant to
19 Section 338(h)(10) of the Internal Revenue Code ... with respect to the purchase of the
20 stock of CEC and CTG." (CT DPUC Docket No. 10-07-09 Application page 8.) The
21 Section 338(h)(10) Election allows UIL to treat the transaction for tax purposes as though
22 it is buying the assets of CNG and SCG instead of acquiring the stock of the corporations.
23 As a result, "the effect of the 338 Election is to eliminate the accumulated deferred income
24 tax ('ADIT') balances of CNG and SCG, which in turn raises rate base." (Id.) The
25 Section 338(h)(10) Election is not a requirement of a stock purchase; rather, UIL and

1 Iberdrola chose to include the Section 338(h)(10) Election as part of the Purchase
2 Agreement.

3
4 **Q. Was the sale of CNG and SCG from Iberdrola to UIL approved?**

5 **A. Yes.**

6
7 **Q. What was the impact on ADIT from the Section 338(h)(10) election?**

8 **A. Because of the Section 338(h)(10) Election, all of the ADIT that had been accumulated on**
9 **the books of CNG and SCG was essentially eliminated as of the date of the transfer. As**
10 **stated at pages 4-5 of the CT DPUC's November 10, 2010 Decision in Docket No. 10-07-**
11 **09:**

12 The 338 Election allows the purchaser of stock to treat the transaction for
13 tax purposes as if the seller is selling and the buyer is purchasing the assets
14 rather than the stock associated with the corporations. The 338 Election
15 would eliminate the accumulated deferred income tax (ADIT) balances of
16 CNG and Southern, which, in turn, would increase rate base.

17 As stated in more detail at page 22 of that Decision:

18 UIL testified that all of CNG's and Southern's assets would be deemed
19 purchased for amounts equal to their net book values at the Closing.
20 However, for tax purposes, the ADIT associated with these assets would be
21 eliminated immediately after the Closing. The lack of ADIT would create
22 differences between the pre-acquisition and the post acquisition levels of
23 the utility plant in service. For CNG and Southern, these differences are
24 the amounts of the existing ADIT immediately prior to the Closing.
25 Responses to Interrogatories GA-67 and OCC-12. Furthermore, UIL stated
26 that the lack of ADIT immediately after the Closing would be recorded on
27 CNG's and Southern's regulated book of accounts used for ratemaking
28 purposes. However, the elimination of the ADIT would not change rates
29 charged to customers. Therefore, CNG's and Southern's rates in effect at
30 the time of the Closing would remain in effect until the Department
31 changes them in future rate proceedings. The elimination of the historical
32 ADIT and the recording of the new deferred taxes would be reviewed in
33 CNG's and Southern's next rate proceedings. Responses to Interrogatories
34 OCC-11 and OCC-12. Nonetheless, UIL agreed that the elimination of the

existing ADIT immediately subsequent to the Closing would increase rate base. Tr. 08/16/10, pp. 55 and 56.

Generally, for rate-making purposes, net ADIT liability amounts are treated as offsets and thereby reduce rate base. The regulatory deferrals and different recognitions for financial and tax reporting create differences between book and tax bases for these rate base items. The ADIT represents the income tax impact of the difference between historical book depreciation expense compared to historical tax depreciation expense. Ratemaking recognizes higher tax early in an asset's life while the actual taxes are deferred for payment later in the asset's life. All things being equal, the unwinding of the ADIT (i.e., when the actual taxes start to be higher than book taxes) increases rate base over time. In the instant Decision, the Department is not making a determination as to how the changes in tax depreciation amounts caused by the Proposed Transaction would affect the levels of tax benefits represented by and/or flowing from the acquired assets.

Q. Did the Connecticut DPUC recognize in its decision in Docket No. 10-07-09 that the extinguishment of the utility ADIT was a negative impact resulting from that transaction and/or that election could have a negative impact on ratepayers?

A. Yes. At page 20 of its Order, the Connecticut DPUC stated that:

A few aspects such as the 338 Election discussed in Section III.C.1. Internal Revenue Code Section 338(h)(10) Election could result in a negative impact on ratepayers.

Q. What did the Connecticut DPUC state in its Decision in that docket about protecting ratepayers from that negative impact?

A. At pages 23-24 of its Decision in Docket No. 10-07-09, the Connecticut DPUC stated as follows:

The Department's position is that the change of control should not impact the cost of utility services that are provided to ratepayers. In subsequent rate case proceedings, CNG and Southern would be required to show that all accounting treatments resulting from the Proposed Transaction will not have adverse impacts on rates. Also, CNG and Southern will be required to file all journal entries to record the eliminations of the ADIT existing prior

1 to the Closing. Furthermore, UIL will be directed to file exhibits,
2 separately for CNG and Southern, showing the total book basis, total tax
3 basis, total accumulated book depreciation and total accumulated tax
4 depreciation for utility plant assets as of the period immediately prior to the
5 Closing. UIL is hereby put on notice that, while the Department is
6 allowing the 338 Election, it is not recommending or by any stretch
7 requiring such an election. UIL proceeds at its own risk regarding the
8 ratemaking treatment that may or may not be afforded any election. The
9 Department intends to safeguard ratepayers from adverse impacts due the
10 change of control.

11
12 **Q. Was the impact on utility rate base and revenue requirements of losing the**
13 **accumulated ADIT addressed in a subsequent CNG base rate case?**

14 **A.** Yes, the impact of extinguishing the ADIT balances as a result of how the change-in-
15 control transaction was structured was addressed in a subsequent base rate case for CNG.

16
17 **Q. What did the Connecticut Public Utility Regulatory Authority ("PURA" or**
18 **"Authority")¹² Order in that CNG rate case, state with respect to the Section**
19 **338(h)(10) election?**

20 **A.** The Authority's January 22, 2014 Decision in Docket No. 13-06-08, Application of
21 Connecticut Natural Gas Corporation to Increase Its Rates and Charges, at pages 10-19.
22 Pages 10-11 stated that:

23 There was significant discussion, with diverging viewpoints, regarding the
24 ADIT issue during the proceeding. At question is an ADIT balance that at
25 the time of the change in control was a credit balance of \$78.3 million.
26 Due to the change in control being accounted for using a 338(h)(10)
27 election, UIL restated its rate base at book value for ratemaking purposes
28 and as a result extinguished its ADIT balance. There are ratemaking
29 implications, as ADIT credit balances are an offset to rate base. The
30 Parties agree that the remaining amount of unamortized ADIT in question,
31 due to amortization since the change in control, is approximately a credit
32 balance of \$62,807,000 as of October 2013 and a credit balance of

¹² Between the change-in-control case and the CNG rate case, the Connecticut utility regulatory authority underwent a reorganization and is now known as the Connecticut Public Utility Regulatory Authority.

1 \$60,272,000 as average rate base for 2014. Late Filed Exhibit No. 51; Tr.
2 11/5/13, pp. 2253 and 2254.

3
4 Two main arguments were presented regarding the ADIT issue, the
5 treatment that should be afforded the ADIT from a transactional view and
6 in keeping with IRS regulations. The Company stated that the acquisition
7 transaction must be viewed in totality. The transaction benefitted CNG, the
8 Company's customers and the State in a variety of ways (e.g., commitment
9 to infrastructure, natural gas growth, job creation, as well as energy
10 efficiency). Moreover, the 338(h)(10) Election is just one of many
11 components of this proceeding and it should not be singled out. The
12 Company contended that ADITs are properly extinguished, due to the
13 benefits of the change in control. The Company also stated that any "hold
14 harmless" adjustment in connection with the 338(h)(10) Election are not
15 warranted and could lead to severe adverse consequences for CNG and its
16 customers. The implementation of a "hold harmless" adjustment would
17 constitute a tax normalization violation that would prohibit CNG from
18 claiming accelerated depreciation going forward – thereby causing the
19 Company to lose a cost-free source of financing with customers losing a
20 future rate base offset. CNG Brief, p. 4.

21 The OCC contended that while CNG relied on the discussion in the Change
22 in Control Decision, the Company failed to provide information in its
23 Application or in responses to interrogatories that would allow the
24 Authority, the OCC or other docket participants to ascertain any financial
25 benefit to ratepayers. It only argued about the detriment of the removal of
26 the ADIT credit. Employee counts have increased, rather than decreased,
27 and corporate costs have drastically increased. Corporate charges have
28 increased from \$18.803 million in the test year to \$22.841 million in the
29 rate year. The amount was subsequently updated to \$23.819 million and is
30 a substantial increase compared to the rate year amount authorized in the
31 prior rate case of \$8,932,293 for affiliate charges, which was prior to the
32 change in control. In addition, when asked during the hearing, "[i]s there
33 anything you can point to that you presented in this case that would show
34 the Authority which direction the revenue requirements have gone pre
35 change in control versus post," the Company responded by saying "it's very
36 difficult to look pre change of control versus post because of all the things
37 that have changed." OCC Brief, pp. 130 and 131.

38 The OCC recommended a "hold harmless" adjustment be made associated
39 with the change in control approved in the Change in Control Decision.
40 This recommendation is for the purpose of protecting ratepayers from the
41 negative financial and rate consequences that result from that transaction,
42 consistent with the Authority's intent to safeguard ratepayers from adverse
43 impacts due to the change of control in that proceeding. Under the Section
44 338(h)(10) election, the acquiring entity is allowed to step up its basis of

1 the acquired assets but as a consequence, the accumulated deferred tax
2 balance existing before the change in control is eliminated, (i.e., the
3 deferred tax liability becomes a current tax). Id., pp. 125 and 126.

4 The OCC disagreed with the Company's position that a potential
5 normalization violation would occur if a "hold harmless" adjustment is
6 reflected in CNG's revenue requirements that result from the current
7 proceeding. The recognition of a rate base credit equal to the pre-
8 acquisition ADIT balance as recommended has been utilized in other State
9 jurisdictions. The OCC contended that the Company witnesses have
10 provided no instances where a utility company has been placed on notice of
11 a normalization violation due to a "hold harmless" adjustment being
12 utilized in a utility rate proceeding after a Section 338(h)(10) election was
13 made. In fact, in the 2nd Supplement to the Response to Interrogatory AC-
14 24, in the December 31, 2012 Form 10-K, outside auditors for UNITIL, the
15 parent company for Northern Utilities, did not find that UNITIL was in an
16 uncertain tax position after a "hold harmless" adjustment in the form of a
17 rate base credit associated with pre-acquisition ADIT balances were
18 reflected in the company's rate case decided earlier in 2012. The OCC
19 claimed that if UNITIL's outside auditors thought there was uncertainty
20 regarding a potential normalization violation after the ratemaking
21 adjustment was reflected in Northern Utilities New Hampshire rate case,
22 Docket DG-11-069, they would have had to make such a disclosure in the
23 notes to the financial statements in this SEC filing. The hold harmless
24 adjustment could be structured in a number of ways. It could be an
25 adjustment that reduces rate base, it could be in the form of a merger
26 adjustment that reduces Operating and Maintenance (O&M) expenses, or
27 could be in the form of revenue credits which are used to offset the
28 Company's revenue requirement. Id., pp. 132 and 133.

29 The Attorney General (AG) argued that UIL's Section 338(h)(10) election
30 eliminated the ADIT account, which may have benefitted the transacting
31 companies but will harm ratepayers unless corrected by the Authority
32 because ratepayers would no longer receive the financial benefits that the
33 ADIT provide. The AG fully supports the OCC's proposal to structure a
34 "hold harmless" adjustment to the CNG rate base or to devise revenue
35 credits that would offset the loss of the ADIT. AG Brief, pp. 14 and 15.

36
37 Extensive additional discussion in that Decision concerns attempts to craft a "hold
38 harmless" remedy that would protect the ratepayers of CNG from the adverse impacts of

1 the Section 338(h)(10) election without incurring a normalization violation under the
2 Internal Revenue Code.¹³

3
4 **Q. Were adverse consequences experienced by CNG ratepayers in that rate case?**

5 **A.** Yes. Due to the Section 338(h)(10) election associated from the transfer of control of
6 CNG from Iberdrola to UIL, CNG's rate base was higher than it otherwise would have
7 been. This was addressed in the PURA's Docket No. 13-06-08 Decision at page 18 as
8 follows:

9 The Authority will proceed with caution on this issue as the consequences
10 of a normalization violation are severe. CNG is rightfully concerned
11 regarding potential negative consequences of a normalization violation and
12 stated that "if the Company considered that an order issued by the
13 Authority constituted a violation of the normalization rules, the imposition
14 of the penalty would be self-executing. The Company would be compelled
15 to file its subsequent tax returns without claiming accelerated
16 depreciation." CNG Brief, pp. 8 and 9. However, the Authority also finds
17 that the evidence and testimony presented in this proceeding is
18 unconvincing in terms of the creation of a normalization violation. The
19 Authority concludes that the only means to a definitive answer on this issue
20 is to go to the source, the IRS. The Authority hereby orders the Company
21 to seek a private letter ruling with regards to the specific question of after
22 extinguishment of an ADIT balance, whether or not a PUC directive to
23 institute a ratemaking mechanism to reflect a credit to ratepayers of ADIT
24 benefits lost through a 338(h)(10) election would constitute a normalization
25 violation. The Company shall file its proposed draft PLR to the PURA, for
26 approval, no later than March 14, 2014.

27 For the current proceeding, the Company is allowed to reflect the
28 extinguishment of ADITs associated with the change of control. However,
29 the Company shall, until further notice from the Authority, track the
30 revenue requirements associated with the credit ADIT balance of
31 \$60,272,000 as average rate base for 2014. In the event of a ruling from
32 the IRS stating that imposing a ratemaking mechanism would not create a
33 normalization violation, the Authority will use this calculation as the basis
34 for a correction of rates.

35

¹³ Id at 10-19.

1 **Q. What has the Connecticut PURA required in order to address the issue of trying to**
2 **protect Connecticut ratepayers from the adverse consequences of that prior change**
3 **of control transaction between Iberdrola and UIL?**

4 A. As described at page 19 of that PURA Decision, and noted above, the Authority has
5 required UIL to track costs and to request a Private Letter Ruling.

6
7 **Q. Was that Private Letter Ruling that was required by the Connecticut PURA ever**
8 **issued?**

9 A. No. The Connecticut PURA rejected UIL's draft PLR request, and a PLR request was
10 ultimately never submitted to the IRS.

11
12 **Q. Why was the utility-drafted PLR request rejected by the Connecticut PURA?**

13 A. In a letter dated May 9, 2014, in conjunction with Docket No. 13-06-08, Order No. 17, the
14 Connecticut PURA stated that its:

15 Order No. 17 requires that the Company "seek a private letter ruling with
16 regards to the specific question of, after extinguishment of an ADIT
17 balance, whether or not a PUC directive to institute a ratemaking
18 mechanism to reflect a credit to ratepayers of ADIT benefits lost through a
19 338(h)(10) election would constitute a normalization violation. The
20 Company shall file proposed draft PLR to the PURA, for approval, no later
21 than March 14, 2014." Order No. 17 relates to discussion of the
22 Accumulated Deferred Income Tax (ADIT) in Section II.B.5 of the
23 Decision. See, Decision, pp. 9-19. The Authority concluded that
24 additional information, in the form of guidance from the United States
25 Internal Revenue Service (IRS), was needed to make a final determination
26 on this issue. To that end, the Authority determined that the appropriate
27 course of action was to direct CNG to seek a Private Letter Ruling from the
28 IRS. Order 17 directs CNG to file with the Authority for its review and
29 approval a proposed request for a Private Letter Ruling from the IRS.

30 The Authority has reviewed and revised the IRS Private Letter Ruling
31 request proposed by CNG. The Authority's revisions to the letter
32 accomplish several key objectives. The revisions are aimed at making the
33 request for a ruling even-handed, neutral, fair, open and transparent on the
34 applicability of the Depreciation Normalization rules contained in 26 U.S.

1 Code § 168(i)(9) and Treas. Reg. §1.167(l)-1, to the ADIT issue raised in
2 this proceeding. The Authority insists that the letter sent to the IRS provide
3 a clear and concise statement of the issue without any advocacy by CNG
4 for its particular position.

5 After the Authority reviews comments, the Authority will issue a letter
6 ruling on the Company's Order No. 17 Compliance filing.

7
8 CNG's proposed letter was more of a CNG advocacy piece containing its
9 legal theory for why the IRS should find a normalization violation. The
10 CNG proposed letter also unfairly provided that CNG's expert witness on
11 this issue in Docket No. 13-06-08, was also representing CNG, before the
12 IRS.

13 The Authority's revision to the Company's letter removes CNG's language
14 referencing the investment tax credit normalization rules and advocating
15 for a finding of a normalization violation. The Authority's revision to the
16 Private Letter Ruling Request removes CNG's expert witness from having
17 a role in representing the Company before the IRS. The Authority is
18 concerned with the ability of this tax attorney to present this issue before
19 the IRS in an unbiased manner and requests the Company employ its in-
20 house counsel before the IRS. The Authority questions CNG's use of the
21 same tax attorney both as an expert witness before the PURA advocating a
22 particular position and as a representative for CNG before the IRS in this
23 Private Letter Ruling process unless the intent is to persuade the IRS to rule
24 consistently with the Company's position presented in Docket No. 13-06-
25 08. In the opinion of the Authority, the IRS should consider this issue from
26 more than the perspective of CNG's shareholders.

27 The Authority has sought a Private Letter Ruling to assist the PURA in its
28 decision making. The Private Letter Ruling request is not intended for
29 CNG to control the Private Letter Ruling process. The PURA is requiring
30 CNG, the taxpayer, to seek this ruling because the Authority requires IRS
31 input on a tax accounting issue in order to make a full and final
32 determination on the ADIT issue raised in Docket No. 13-06-08.
33 Therefore, CNG is acting in its capacity as a regulated public service
34 company under the oversight and direction of the PURA in seeking this
35 Private Letter Ruling. If the IRS requires additional information or wishes
36 to learn the positions of the affected entities, the PURA, CNG and the
37 Office of Consumer Counsel (OCC), should be able to participate in the
38 IRS process on an equal basis. To that end, the Authority's revisions
39 provide for greater transparency and equity to the PURA and the OCC by
40 including them in the discussions between CNG and the IRS and by giving
41 the PURA and the OCC the opportunity to participate in any conferences
42 held by the IRS on this matter.
43

1 A copy of that May 9, 2014 letter from the Connecticut PURA to CNG is presented in
2 Attachment RCS-10. Based on subsequent events, involving a subsequent change-of-
3 control proceeding involving the same two utilities (CNG and SCG) and instituting
4 agreed-upon mitigation measures to protect the CNG and SCG ratepayers from the
5 adverse consequences of the ADIT extinguishment that had occurred in the previous
6 change-of-control transaction, the request for the PLR was ultimately never submitted to
7 the IRS.

8 **Q. Please explain.**

9 A. The ratepayer harms outlined in the CNG rate case that resulted from the Section
10 338(h)(10) Election were the subject of an appeal of the CNG rate case ruling and were
11 also areas of particular concern in a subsequent proposed merger proceeding involving
12 Iberdrola and UIL because it involved the same entities, and thus presented a regulatory
13 opportunity to address and remedy the harm to ratepayers associated with the prior
14 change-in-control transaction that had extinguished utility ADIT balances. Just a few
15 years ago, the two Connecticut gas distribution utilities, CNG and SCG, were transferred
16 from Iberdrola to UIL. As documented in the CNG rate case, Docket No. 13-06-08, the
17 Section 338(h)(10) Election had resulted in a higher rate base for CNG and higher rates to
18 CNG ratepayers. Then these same parent companies, UIL and Iberdrola, as part of their
19 proposed transaction in Connecticut PURA Docket No. 15-03-45, sought to transfer these
20 same two Connecticut gas distribution utilities, CNG and SCG, back to Iberdrola (along
21 with a Connecticut electric utility, United Illuminating). Moreover, the applicants in that
22 case sought to do this without remedying the ratepayer harm that resulted from their
23 previous transfer of these same two Connecticut gas distribution utilities. This
24 transferring of these two Connecticut gas distribution utilities, CNG and SCG, first from

1 Iberdrola to UIL, and then back to Iberdrola, with a focus on shareholder profit to the
2 detriment of ratepayers, raised serious public interest concerns.

3
4 **Q. How were those serious public interest concerns ultimately addressed and resolved?**

5 A. In Connecticut PURA Docket No. 15-03-45, concerns raised in the proceeding regarding
6 the proposed Iberdrola-UIL merger had not been resolved to the satisfaction of the
7 Connecticut PURA. Accordingly, on June 30, 2015 the PURA issued a proposed final
8 decision in that docket rejecting that merger. On July 1, 2015, the PURA rejected a motion
9 from the applicants in that case that requested that the Authority (1) suspend the current
10 procedural schedule; (2) extend the schedule by 2 months; and (3) reopen the record in the
11 proceeding to permit the Applicants to file additional information, commitments and
12 assurances to address the concerns set forth in the Proposed Decision. In response to
13 those rulings, the applicants withdrew their request for merger approval. The applicants in
14 that case subsequently engaged in serious discussions with key parties to that case,
15 including the Connecticut Office of Consumer Counsel ("OCC"). As a result of such
16 discussions, using the concepts of rate moratoriums and base rate credits similar to the
17 ones that had been used in some of the Pennsylvania change-in-control proceedings that I
18 described above¹⁴, mitigation measures for the prior extinguishment of the Connecticut
19 utility ADIT balances were ultimately agreed upon (as well as other issues). Additional
20 conditions to approval of the proposed merger, including such ratepayer protections, were
21 memorialized in a settlement reached between OCC and the Applicants that was filed
22 Connecticut PURA Docket No. 15-07-38 on September 18, 2015. The protections
23 included a combination of customer rate credits and base rate freezes for the two
24 Connecticut gas distribution utilities, CNG and SCG.

25

¹⁴ Also see, e.g., Attachments RCS-5 and RCS-6

1 **Q. What specific measures were applied?**

2 A. The following measures from the settlement reached between OCC and the Applicants
3 that was filed Connecticut PURA Docket No. 15-07-38 on September 18, 2015 were
4 applied:

5 **2. Customer Rate Credits** – The Applicants will provide \$20 million in
6 customer rate credits in the aggregate to customers of The United
7 Illuminating Company (“UI”), Connecticut Natural Gas Corporation
8 (“CNG”) and The Southern Connecticut Gas Company (“SCG” and
9 collectively with CNG and UI, the “UIL Utilities”) in the first year
10 following the closing.

11 a. OCC recommends the following approach for allocating the \$20 million
12 among the three UIL Utilities: A one-time, \$20 million rate credit to
13 customers will be allocated to UI, SCG and CNG based on the total number
14 of retail customers at each utility in proportion to the total number of retail
15 customers of the three UIL Utilities. Each Company’s rate credit will be
16 allocated to firm retail customer classes (i.e., residential, commercial and
17 industrial) based upon their proportional share of the monthly customer
18 charges, and will appear on the bill as a uniform dollar amount credit for
19 each separate customer class as a separate line item, along with an
20 explanatory bill message. All customers within a retail customer class shall
21 receive the same rate credit dollar amount. The rate credits will be applied
22 to billing cycles in or before the third full billing month following the
23 closing of the Proposed Transaction.

24 **3. Additional Ratepayer Benefits for CNG Customers** – The Applicants
25 will provide \$12.5 million in rate credits to customers of CNG over the ten-
26 year period of 2018-2027 (\$1.25 million per year).

27 **4. Additional Ratepayer Benefits for SCG Customers** – The Applicants
28 will provide the following benefits to customers of SCG:

29 a. \$1.6 million in ratepayer savings associated with doubling SCG’s bare
30 steel/cast iron main replacement (from \$11 million per year to \$22 million
31 per year) over a three-year period without seeking recovery until the next
32 SCG rate case.

33 b. \$7.5 million in rate credits over the ten-year period of 2018-2027 (\$0.75
34 million per year).

35 **5. Base Rate Freezes** – The Applicants commit to distribution base rate
36 freezes for the UIL Utilities, which will result in significant customer
37 savings. Specifically: ...

38 CNG’s and SCG’s respective current distribution base rates will remain
39 with no new distribution base rates in effect before at least January 1, 2018.

1
2 **Q. Which provisions were designed to address ratepayer protections to remedy the**
3 **issues concerning the previous extinguishment of CNG and SCG utility ADIT**
4 **balances that resulted from the previous change-in-control and which had not been**
5 **adequately remedied, due to the normalization concerns, in the post-transfer CNG**
6 **rate case?**

7 A. My understanding is that the specific additional rate credits for CNG provided for in
8 paragraph 3 and for SCG in paragraph 4(b) above, coupled with the rate moratorium
9 provisions for CNG and SCG in paragraph 5 provide for the agreed-upon ratepayer
10 protections that address and help remedy the harm to ratepayers that otherwise would be
11 attributed to the previous extinguishment of CNG and SCG utility ADIT balances from
12 the previous change-in-control transaction between UIL and Iberdrola involving those two
13 Connecticut gas distribution utilities.

14
15 **Q. Have the experiences described above provided you with insights on best regulatory**
16 **practices for addressing change-in-control transactions that are structured in a**
17 **manner to extinguish utility ADIT balances?**

18 A. Yes, it has.

19
20 **Q. Please explain what you have learned about best practices.**

21 A. First, the public interest will usually be best served if a proposed utility change-in-control
22 transaction can be structured in a manner that does not entail the extinguishment of utility
23 ADIT balances.

24 Second, if a private letter ruling is going to be required in order to address issues
25 relating to tax normalization requirements, the PLR should be drafted in a factually
26 accurate and neutral manner, and should be subject to review and approval by the

1 regulatory authority prior to submission to the IRS, rather than allowing the drafting of the
2 PLR request to become an exercise in utility self-serving advocacy.

3 Third, the regulator should require that the PLR be obtained prior to approving a
4 change-in-control transaction that would result in extinguishing the utility ADIT balances.
5 It is preferable to have the PLR results in advance of granting approval because a viable
6 mitigation to protect utility ratepayers from the harm the transaction would otherwise
7 produce (i.e., from the higher rate base and higher rates) is needed that will not result in
8 the ability of the utility to use accelerated tax depreciation.

9 Fourth, if a viable method for mitigation of ratepayer harm that does not violate tax
10 normalization requirements cannot be developed, unless there are other compelling
11 reasons to approve the transaction, the ratepayer harm in itself could be significant enough
12 to warrant a ruling that the proposed transaction is not in the public interest.

13 Fifth, because the applicants in a proposed change-of-control transaction are the
14 parties that are creating the regulatory issues, including issues related to extinguishing the
15 existing utility ADIT balances because of how their proposed transaction is structured, the
16 costs of developing tax normalization challenge-proof mitigation of ratepayer harm, such
17 as the cost for obtaining a PLR, are change-of-control transaction costs that should be
18 borne by applicants and not recovered from utility ratepayers.

19
20 **Q. Please summarize your findings and recommendations on the ADIT issue.**

21 **A.** The Applicants have proposed to structure their proposed transfer of ownership of the
22 Willow Valley utility and its CCN as an asset sale that would result in extinguishing the
23 utility's existing ADIT. This aspect of the proposed transaction, unless remediated, would
24 harm ratepayers because the loss of the non-investor-supplied cost-free capital, other
25 things being equal, would significantly increase the utility's rate base. The increased rate
26 base would be caused solely by the change-in-control transaction and how it was

1 structured. Failure to find a viable method of protecting ratepayers from the harm caused
2 by the proposed transaction could be one reason for rejecting the proposed transaction as
3 structured by the applicants. Unless the Applicants can present a workable method of
4 protecting Willow Valley ratepayers from the significantly increased rate base that would
5 result from the way they have proposed to structure their transaction, which extinguishes
6 the utility's existing ADIT, my recommendation is for the Commission to reject their
7 requested transaction.

8
9 **Q. Does this conclude your surrebuttal testimony?**

10 **A. Yes, it does.**

Attachment RCS-1
QUALIFICATIONS OF RALPH C. SMITH

Accomplishments

Mr. Smith's professional credentials include being a Certified Financial Planner™ professional, a Certified Rate of Return Analyst, a licensed Certified Public Accountant and attorney. He functions as project manager on consulting projects involving utility regulation, regulatory policy and ratemaking and utility management. His involvement in public utility regulation has included project management and in-depth analyses of numerous issues involving telephone, electric, gas, and water and sewer utilities.

Mr. Smith has performed work in the field of utility regulation on behalf of industry, public service commission staffs, state attorney generals, municipalities, and consumer groups concerning regulatory matters before regulatory agencies in Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, Nevada, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Washington DC, West Virginia, Canada, Federal Energy Regulatory Commission and various state and federal courts of law. He has presented expert testimony in regulatory hearings on behalf of utility commission staffs and intervenors on several occasions.

Project manager in Larkin & Associates' review, on behalf of the Georgia Commission Staff, of the budget and planning activities of Georgia Power Company; supervised 13 professionals; coordinated over 200 interviews with Company budget center managers and executives; organized and edited voluminous audit report; presented testimony before the Commission. Functional areas covered included fossil plant O&M, headquarters and district operations, internal audit, legal, affiliated transactions, and responsibility reporting. All of our findings and recommendations were accepted by the Commission.

Key team member in the firm's management audit of the Anchorage Water and Wastewater Utility on behalf of the Alaska Commission Staff, which assessed the effectiveness of the Utility's operations in several areas; responsible for in-depth investigation and report writing in areas involving information systems, finance and accounting, affiliated relationships and transactions, and use of outside contractors. Testified before the Alaska Commission concerning certain areas of the audit report. AWWU concurred with each of Mr. Smith's 40 plus recommendations for improvement.

Co-consultant in the analysis of the issues surrounding gas transportation performed for the law firm of Cravath, Swaine & Moore in conjunction with the case of Reynolds Metals Co. vs. the Columbia Gas System, Inc.; drafted in-depth report concerning the regulatory treatment at both state and federal levels of issues such as flexible pricing and mandatory gas transportation.

Lead consultant and expert witness in the analysis of the rate increase request of the City of Austin - Electric Utility on behalf of the residential consumers. Among the numerous ratemaking issues addressed were the economies of the Utility's employment of outside services; provided both written and oral testimony outlining recommendations and their bases. Most of Mr. Smith's recommendations were adopted by the City Council and Utility in a settlement.

Key team member performing an analysis of the rate stabilization plan submitted by the Southern Bell Telephone & Telegraph Company to the Florida PSC; performed comprehensive analysis of the Company's projections and budgets which were used as the basis for establishing rates.

Lead consultant in analyzing Southwestern Bell Telephone separations in Missouri; sponsored the complex technical analysis and calculations upon which the firm's testimony in that case was based. He has also assisted in analyzing changes in depreciation methodology for setting telephone rates.

Lead consultant in the review of gas cost recovery reconciliation applications of Michigan Gas Utilities Company, Michigan Consolidated Gas Company, and Consumers Power Company. Drafted recommendations regarding the appropriate rate of interest to be applied to any over or under collections and the proper procedures and allocation methodology to be used to distribute any refunds to customer classes.

Lead consultant in the review of Consumers Power Company's gas cost recovery refund plan. Addressed appropriate interest rate and compounding procedures and proper allocation methodology.

Project manager in the review of the request by Central Maine Power Company for an increase in rates. The major area addressed was the propriety of the Company's ratemaking attrition adjustment in relation to its corporate budgets and projections.

Project manager in an engagement designed to address the impacts of the Tax Reform Act of 1986 on gas distribution utility operations of the Northern States Power Company. Analyzed the reduction in the corporate tax rate, uncollectibles reserve, ACRS, unbilled revenues, customer advances, CIAC, and timing of TRA-related impacts associated with the Company's tax liability.

Project manager and expert witness in the determination of the impacts of the Tax Reform Act of 1986 on the operations of Connecticut Natural Gas Company on behalf of the Connecticut Department of Public Utility Control - Prosecutorial Division, Connecticut Attorney General, and Connecticut Department of Consumer Counsel.

Lead Consultant for The Minnesota Department of Public Service ("DPS") to review the Minnesota Incentive Plan ("Incentive Plan") proposal presented by Northwestern Bell Telephone Company ("NWB") doing business as U S West Communications ("USWC"). Objective was to express an opinion as to whether current rates addressed by the plan were appropriate from a Minnesota intrastate revenue requirements and accounting perspective, and to assist in developing recommended modifications to NWB's proposed Plan.

Performed a variety of analytical and review tasks related to our work effort on this project. Obtained and reviewed data and performed other procedures as necessary (1) to obtain an understanding of the Company's Incentive Plan filing package as it relates to rate base, operating income, revenue requirements, and plan operation, and (2) to formulate an opinion concerning the reasonableness of current rates and of amounts included within the Company's Incentive Plan filing. These procedures included requesting and reviewing extensive discovery, visiting the Company's offices to review data, issuing follow-up information requests in many instances, telephone and on-site discussions with Company representatives, and frequent discussions with counsel and DPS Staff assigned to the project.

Lead Consultant in the regulatory analysis of Jersey Central Power & Light Company for the Department of the Public Advocate, Division of Rate Counsel. Tasks performed included on-site review and audit of Company, identification and analysis of specific issues, preparation of data requests, testimony, and cross examination questions. Testified in Hearings.

Assisted the NARUC Committee on Management Analysis with drafting the Consultant Standards for Management Audits.

Presented training seminars covering public utility accounting, tax reform, ratemaking, affiliated transaction auditing, rate case management, and regulatory policy in Maine, Georgia, Kentucky, and Pennsylvania. Seminars were presented to commission staffs and consumer interest groups.

Previous Positions

With Larkin, Chapski and Co., the predecessor firm to Larkin & Associates, was involved primarily in utility regulatory consulting, and also in tax planning and tax research for businesses and individuals, tax return preparation and review, and independent audit, review and preparation of financial statements.

Installed computerized accounting system for a realty management firm.

Education

Bachelor of Science in Administration in Accounting, with distinction, University of Michigan, Dearborn, 1979.

Master of Science in Taxation, Walsh College, Michigan, 1981. Master's thesis dealt with investment tax credit and property tax on various assets.

Juris Doctor, cum laude, Wayne State University Law School, Detroit, Michigan, 1986. Recipient of American Jurisprudence Award for academic excellence.

Continuing education required to maintain CPA license and CFP® certificate.

Passed all parts of CPA examination in first sitting, 1979. Received CPA certificate in 1981 and Certified Financial Planning certificate in 1983. Admitted to Michigan and Federal bars in 1986.

Michigan Bar Association.

American Bar Association, sections on public utility law and taxation.

Partial list of utility cases participated in:

79-228-EL-FAC	Cincinnati Gas & Electric Company (Ohio PUC)
79-231-EL-FAC	Cleveland Electric Illuminating Company (Ohio PUC)
79-535-EL-AIR	East Ohio Gas Company (Ohio PUC)
80-235-EL-FAC	Ohio Edison Company (Ohio PUC)
80-240-EL-FAC	Cleveland Electric Illuminating Company (Ohio PUC)
U-1933*	Tucson Electric Power Company (Arizona Corp. Commission)
U-6794	Michigan Consolidated Gas Co. --16 Refunds (Michigan PSC)
81-0035TP	Southern Bell Telephone Company (Florida PSC)
81-0095TP	General Telephone Company of Florida (Florida PSC)
81-308-EL-EFC	Dayton Power & Light Co.- Fuel Adjustment Clause (Ohio PUC)
810136-EU	Gulf Power Company (Florida PSC)
GR-81-342	Northern States Power Co. -- E-002/Minnesota (Minnesota PUC)
Tr-81-208	Southwestern Bell Telephone Company (Missouri PSC))
U-6949	Detroit Edison Company (Michigan PSC)
8400	East Kentucky Power Cooperative, Inc. (Kentucky PSC)
18328	Alabama Gas Corporation (Alabama PSC)
18416	Alabama Power Company (Alabama PSC)
820100-EU	Florida Power Corporation (Florida PSC)
8624	Kentucky Utilities (Kentucky PSC)
8648	East Kentucky Power Cooperative, Inc. (Kentucky PSC)
U-7236	Detroit Edison - Burlington Northern Refund (Michigan PSC)
U6633-R	Detroit Edison - MRCS Program (Michigan PSC)
U-6797-R	Consumers Power Company -MRCS Program (Michigan PSC)
U-5510-R	Consumers Power Company - Energy conservation Finance Program (Michigan PSC)
82-240E	South Carolina Electric & Gas Company (South Carolina PSC)
7350	Generic Working Capital Hearing (Michigan PSC)
RH-1-83	Westcoast Transmission Co., (National Energy Board of Canada)
820294-TP	Southern Bell Telephone & Telegraph Co. (Florida PSC)
82-165-EL-EFC (Subfile A)	Toledo Edison Company(Ohio PUC)
82-168-EL-EFC	Cleveland Electric Illuminating Company (Ohio PUC)
830012-EU	Tampa Electric Company (Florida PSC)
U-7065	The Detroit Edison Company - Fermi II (Michigan PSC)
8738	Columbia Gas of Kentucky, Inc. (Kentucky PSC)
ER-83-206	Arkansas Power & Light Company (Missouri PSC)
U-4758	The Detroit Edison Company -- Refunds (Michigan PSC)
8836	Kentucky American Water Company (Kentucky PSC)
8839	Western Kentucky Gas Company (Kentucky PSC)
83-07-15	Connecticut Light & Power Co. (Connecticut DPU)
81-0485-WS	Palm Coast Utility Corporation (Florida PSC)
U-7650	Consumers Power Co. (Michigan PSC)
83-662	Continental Telephone Company of California, (Nevada PSC)
U-6488-R	Detroit Edison Co., FAC & PIPAC Reconciliation (Michigan PSC)
U-15684	Louisiana Power & Light Company (Louisiana PSC)
7395 & U-7397	Campaign Ballot Proposals (Michigan PSC)
820013-WS	Seacoast Utilities (Florida PSC)
U-7660	Detroit Edison Company (Michigan PSC)
83-1039	CP National Corporation (Nevada PSC)
U-7802	Michigan Gas Utilities Company (Michigan PSC)
83-1226	Sierra Pacific Power Company (Nevada PSC)
830465-EI	Florida Power & Light Company (Florida PSC)
U-7777	Michigan Consolidated Gas Company (Michigan PSC)
U-7779	Consumers Power Company (Michigan PSC)

U-7480-R	Michigan Consolidated Gas Company (Michigan PSC)
U-7488-R	Consumers Power Company – Gas (Michigan PSC)
U-7484-R	Michigan Gas Utilities Company (Michigan PSC)
U-7550-R	Detroit Edison Company (Michigan PSC)
U-7477-R**	Indiana & Michigan Electric Company (Michigan PSC)
18978	Continental Telephone Co. of the South Alabama (Alabama PSC)
R-842583	Duquesne Light Company (Pennsylvania PUC)
R-842740	Pennsylvania Power Company (Pennsylvania PUC)
850050-EI	Tampa Electric Company (Florida PSC)
16091	Louisiana Power & Light Company (Louisiana PSC)
19297	Continental Telephone Co. of the South Alabama (Alabama PSC)
76-18788AA	
&76-18793AA	Detroit Edison - Refund - Appeal of U-4807 (Ingham County, Michigan Circuit Court)
85-53476AA	
& 85-534785AA	Detroit Edison Refund - Appeal of U-4758 (Ingham County, Michigan Circuit Court)
U-8091/U-8239	Consumers Power Company - Gas Refunds (Michigan PSC)
TR-85-179**	United Telephone Company of Missouri (Missouri PSC)
85-212	Central Maine Power Company (Maine PSC)
ER-85646001	
& ER-85647001	New England Power Company (FERC)
850782-EI &	
850783-EI	Florida Power & Light Company (Florida PSC)
R-860378	Duquesne Light Company (Pennsylvania PUC)
R-850267	Pennsylvania Power Company (Pennsylvania PUC)
851007-WU	
& 840419-SU	Florida Cities Water Company (Florida PSC)
G-002/GR-86-160	Northern States Power Company (Minnesota PSC)
7195 (Interim)	Gulf States Utilities Company (Texas PUC)
87-01-03	Connecticut Natural Gas Company (Connecticut PUC))
87-01-02	Southern New England Telephone Company (Connecticut Department of Public Utility Control)
3673-	Georgia Power Company (Georgia PSC)
29484	Long Island Lighting Co. (New York Dept. of Public Service)
U-8924	Consumers Power Company – Gas (Michigan PSC)
Docket No. 1	Austin Electric Utility (City of Austin, Texas)
Docket E-2, Sub 527	Carolina Power & Light Company (North Carolina PUC)
870853	Pennsylvania Gas and Water Company (Pennsylvania PUC)
880069**	Southern Bell Telephone Company (Florida PSC)
U-1954-88-102	Citizens Utilities Rural Company, Inc. & Citizens Utilities Company, Kingman Telephone Division (Arizona CC)
T E-1032-88-102	Illinois Bell Telephone Company (Illinois CC)
89-0033	Puget Sound Power & Light Company (Washington UTC))
U-89-2688-T	Philadelphia Electric Company (Pennsylvania PUC)
R-891364	Potomac Electric Power Company (District of Columbia PSC)
F.C. 889	Niagara Mohawk Power Corporation, et al Plaintiffs, v. Gulf+Western, Inc. et al, defendants (Supreme Court County of Onondaga, State of New York)
Case No. 88/546*	Duquesne Light Company, et al, plaintiffs, against Gulf+Western, Inc. et al, defendants (Court of the Common Pleas of Allegheny County, Pennsylvania Civil Division)
87-11628*	Florida Power & Light Company (Florida PSC)
890319-EI	Gulf Power Company (Florida PSC)
891345-EI	Jersey Central Power & Light Company (BPU)
ER 8811 0912J	Hawaiian Electric Company (Hawaii PUCs)
6531	

R0901595	Equitable Gas Company (Pennsylvania Consumer Counsel)
90-10	Artesian Water Company (Delaware PSC)
89-12-05	Southern New England Telephone Company (Connecticut PUC)
900329-WS	Southern States Utilities, Inc. (Florida PSC)
90-12-018	Southern California Edison Company (California PUC)
90-E-1185	Long Island Lighting Company (New York DPS)
R-911966	Pennsylvania Gas & Water Company (Pennsylvania PUC)
I.90-07-037, Phase II	(Investigation of OPEBs) Department of the Navy and all Other Federal Executive Agencies (California PUC)
U-1551-90-322	Southwest Gas Corporation (Arizona CC)
U-1656-91-134	Sun City Water Company (Arizona RUCO)
U-2013-91-133	Havasu Water Company (Arizona RUCO)
91-174***	Central Maine Power Company (Department of the Navy and all Other Federal Executive Agencies)
U-1551-89-102	Southwest Gas Corporation - Rebuttal and PGA Audit (Arizona Corporation Commission)
& U-1551-89-103	Hawaiian Electric Company (Hawaii PUC)
Docket No. 6998	Intrastate Access Charge Methodology, Pool and Rates
TC-91-040A and	Local Exchange Carriers Association and South Dakota
TC-91-040B	Independent Telephone Coalition
9911030-WS &	General Development Utilities - Port Malabar and
911-67-WS	West Coast Divisions (Florida PSC)
922180	The Peoples Natural Gas Company (Pennsylvania PUC)
7233 and 7243	Hawaiian Nonpension Postretirement Benefits (Hawaiian PUC)
R-00922314	
& M-920313C006	Metropolitan Edison Company (Pennsylvania PUC)
R00922428	Pennsylvania American Water Company (Pennsylvania PUC)
E-1032-92-083 &	
U-1656-92-183	Citizens Utilities Company, Agua Fria Water Division (Arizona Corporation Commission)
92-09-19	Southern New England Telephone Company (Connecticut PUC)
E-1032-92-073	Citizens Utilities Company (Electric Division), (Arizona CC)
UE-92-1262	Puget Sound Power and Light Company (Washington UTC))
92-345	Central Maine Power Company (Maine PUC)
R-932667	Pennsylvania Gas & Water Company (Pennsylvania PUC)
U-93-60**	Matanuska Telephone Association, Inc. (Alaska PUC)
U-93-50**	Anchorage Telephone Utility (Alaska PUC)
U-93-64	PTI Communications (Alaska PUC)
7700	Hawaiian Electric Company, Inc. (Hawaii PUC)
E-1032-93-111 &	Citizens Utilities Company - Gas Division
U-1032-93-193	(Arizona Corporation Commission)
R-00932670	Pennsylvania American Water Company (Pennsylvania PUC)
U-1514-93-169/	Sale of Assets CC&N from Contel of the West, Inc. to
E-1032-93-169	Citizens Utilities Company (Arizona Corporation Commission)
7766	Hawaiian Electric Company, Inc. (Hawaii PUC)
93-2006- GA-AIR*	The East Ohio Gas Company (Ohio PUC)
94-E-0334	Consolidated Edison Company (New York DPS)
94-0270	Inter-State Water Company (Illinois Commerce Commission)
94-0097	Citizens Utilities Company, Kauai Electric Division (Hawaii PUC)
PU-314-94-688	Application for Transfer of Local Exchanges (North Dakota PSC)
94-12-005-Phase I	Pacific Gas & Electric Company (California PUC)
R-953297	UGI Utilities, Inc. - Gas Division (Pennsylvania PUC)
95-03-01	Southern New England Telephone Company (Connecticut PUC)
95-0342	Consumer Illinois Water, Kankakee Water District (Illinois CC)
94-996-EL-AIR	Ohio Power Company (Ohio PUC)
95-1000-E	South Carolina Electric & Gas Company (South Carolina PSC)

Non-Docketed	Citizens Utility Company - Arizona Telephone Operations
Staff Investigation	(Arizona Corporation Commission)
E-1032-95-473	Citizens Utility Co. - Northern Arizona Gas Division (Arizona CC)
E-1032-95-433	Citizens Utility Co. - Arizona Electric Division (Arizona CC)
	Collaborative Ratemaking Process Columbia Gas of Pennsylvania
	(Pennsylvania PUC)
GR-96-285	Missouri Gas Energy (Missouri PSC)
94-10-45	Southern New England Telephone Company (Connecticut PUC)
A.96-08-001 et al.	California Utilities' Applications to Identify Sunk Costs of Non-
	Nuclear Generation Assets, & Transition Costs for Electric Utility
	Restructuring, & Consolidated Proceedings (California PUC)
96-324	Bell Atlantic - Delaware, Inc. (Delaware PSC)
96-08-070, et al.	Pacific Gas & Electric Co., Southern California Edison Co. and
	San Diego Gas & Electric Company (California PUC)
97-05-12	Connecticut Light & Power (Connecticut PUC)
R-00973953	Application of PECO Energy Company for Approval of its
	Restructuring Plan Under Section 2806 of the Public Utility Code
	(Pennsylvania PUC)
97-65	Application of Delmarva Power & Light Co. for Application of a
	Cost Accounting Manual and a Code of Conduct (Delaware PSC)
16705	Entergy Gulf States, Inc. (Cities Steering Committee)
E-1072-97-067	Southwestern Telephone Co. (Arizona Corporation Commission)
Non-Docketed	Delaware - Estimate Impact of Universal Services Issues
Staff Investigation	(Delaware PSC)
PU-314-97-12	US West Communications, Inc. Cost Studies (North Dakota PSC)
97-0351	Consumer Illinois Water Company (Illinois CC)
97-8001	Investigation of Issues to be Considered as a Result of Restructuring of Electric
	Industry (Nevada PSC)
U-0000-94-165	Generic Docket to Consider Competition in the Provision
	of Retail Electric Service (Arizona Corporation Commission)
98-05-006-Phase I	San Diego Gas & Electric Co., Section 386 costs (California PUC)
9355-U	Georgia Power Company Rate Case (Georgia PUC)
97-12-020 - Phase I	Pacific Gas & Electric Company (California PUC)
U-98-56, U-98-60,	Investigation of 1998 Intrastate Access charge filings
U-98-65, U-98-67	(Alaska PUC)
(U-99-66, U-99-65,	Investigation of 1999 Intrastate Access Charge filing
U-99-56, U-99-52)	(Alaska PUC)
Phase II of	
97-SCCC-149-GIT	Southwestern Bell Telephone Company Cost Studies (Kansas CC)
PU-314-97-465	US West Universal Service Cost Model (North Dakota PSC)
Non-docketed	Bell Atlantic - Delaware, Inc., Review of New Telecomm.
Assistance	and Tariff Filings (Delaware PSC)
Contract Dispute	City of Zeeland, MI - Water Contract with the City of Holland, MI
	(Before an arbitration panel)
Non-docketed Project	City of Danville, IL - Valuation of Water System (Danville, IL)
Non-docketed Project	Village of University Park, IL - Valuation of Water and
	Sewer System (Village of University Park, Illinois)

E-1032-95-417	Citizens Utility Co., Maricopa Water/Wastewater Companies et al. (Arizona Corporation Commission)
T-1051B-99-0497	Proposed Merger of the Parent Corporation of Qwest Communications Corporation, LCI International Telecom Corp., and US West Communications, Inc. (Arizona CC)
T-01051B-99-0105	US West Communications, Inc. Rate Case (Arizona CC)
A00-07-043	Pacific Gas & Electric - 2001 Attrition (California PUC)
T-01051B-99-0499	US West/Quest Broadband Asset Transfer (Arizona CC)
99-419/420	US West, Inc. Toll and Access Rebalancing (North Dakota PSC)
PU314-99-119	US West, Inc. Residential Rate Increase and Cost Study Review (North Dakota PSC)
98-0252	Ameritech - Illinois, Review of Alternative Regulation Plan (Illinois CUB)
00-108	Delmarva Billing System Investigation (Delaware PSC)
U-00-28	Matanuska Telephone Association (Alaska PUC)
Non-Docketed	Management Audit and Market Power Mitigation Analysis of the Merged Gas System Operation of Pacific Enterprises and Enova Corporation (California PUC)
00-11-038	Southern California Edison (California PUC)
00-11-056	Pacific Gas & Electric (California PUC)
00-10-028	The Utility Reform Network for Modification of Resolution E-3527 (California PUC)
98-479	Delmarva Power & Light Application for Approval of its Electric and Fuel Adjustments Costs (Delaware PSC)
99-457	Delaware Electric Cooperative Restructuring Filing (Delaware PSC)
99-582	Delmarva Power & Light dba Conectiv Power Delivery Analysis of Code of Conduct and Cost Accounting Manual (Delaware PSC)
99-03-04	United Illuminating Company Recovery of Stranded Costs (Connecticut OCC)
99-03-36	Connecticut Light & Power (Connecticut OCC)
Civil Action No.	
98-1117	West Penn Power Company vs. PA PUC (Pennsylvania PSC)
Case No. 12604	Upper Peninsula Power Company (Michigan AG)
Case No. 12613	Wisconsin Public Service Commission (Michigan AG)
41651	Northern Indiana Public Service Co Overearnings investigation (Indiana UCC)
13605-U	Savannah Electric & Power Company - FCR (Georgia PSC)
14000-U	Georgia Power Company Rate Case/M&S Review (Georgia PSC)
13196-U	Savannah Electric & Power Company Natural Gas Procurement and Risk Management/Hedging Proposal, Docket No. 13196-U (Georgia PSC)
Non-Docketed	Georgia Power Company & Savannah Electric & Power FPR Company Fuel Procurement Audit (Georgia PSC)
Non-Docketed	Transition Costs of Nevada Vertically Integrated Utilities (US Department of Navy)
Application No.	Post-Transition Ratemaking Mechanisms for the Electric Industry
99-01-016,	Restructuring (US Department of Navy)
Phase I	
99-02-05	Connecticut Light & Power (Connecticut OCC)
01-05-19-RE03	Yankee Gas Service Application for a Rate Increase, Phase I-2002-IERM (Connecticut OCC)
G-01551A-00-0309	Southwest Gas Corporation, Application to amend its rate Schedules (Arizona CC)
00-07-043	Pacific Gas & Electric Company Attrition & Application for a rate increase (California PUC)

97-12-020	Pacific Gas & Electric Company Rate Case (California PUC)
Phase II	United Illuminating Company (Connecticut OCC)
01-10-10	Georgia Power FCR (Georgia PSC)
13711-U	Verizon Delaware § 271(Delaware DPA)
02-001	Blue Valley Telephone Company Audit/General Rate Investigation (Kansas CC)
02-BLVT-377-AUD	S&T Telephone Cooperative Audit/General Rate Investigation (Kansas CC)
02-S&TT-390-AUD	Sunflower Telephone Company Inc., Audit/General Rate Investigation (Kansas CC)
01-SFLT-879-AUD	Bluestem Telephone Company, Inc. Audit/General Rate Investigation (Kansas CC)
01-BSTT-878-AUD	
P404, 407, 520, 413	
426, 427, 430, 421/	
CI-00-712	Sherburne County Rural Telephone Company, dba as Connections, Etc. (Minnesota DOC)
U-01-85	ACS of Alaska, dba as Alaska Communications Systems (ACS), Rate Case (Alaska Regulatory Commission PAS)
U-01-34	ACS of Anchorage, dba as Alaska Communications Systems (ACS), Rate Case (Alaska Regulatory Commission PAS)
U-01-83	ACS of Fairbanks, dba as Alaska Communications Systems (ACS), Rate Case (Alaska Regulatory Commission PAS)
U-01-87	ACS of the Northland, dba as Alaska Communications Systems (ACS), Rate Case (Alaska Regulatory Commission PAS)
96-324, Phase II	Verizon Delaware, Inc. UNE Rate Filing (Delaware PSC)
03-WHST-503-AUD	Wheat State Telephone Company (Kansas CC)
04-GNBT-130-AUD	Golden Belt Telephone Association (Kansas CC)
Docket 6914	Shoreham Telephone Company, Inc. (Vermont BPU)
Docket No.	
E-01345A-06-009	Arizona Public Service Company (Arizona Corporation Commission)
Case No.	
05-1278-E-PC-PW-42T	Appalachian Power Company and Wheeling Power Company both d/b/a American Electric Power (West Virginia PSC)
Docket No. 04-0113	Hawaiian Electric Company (Hawaii PUC)
Case No. U-14347	Consumers Energy Company (Michigan PSC)
Case No. 05-725-EL-UNC	Cincinnati Gas & Electric Company (PUC of Ohio)
Docket No. 21229-U	Savannah Electric & Power Company (Georgia PSC)
Docket No. 19142-U	Georgia Power Company (Georgia PSC)
Docket No.	
03-07-01RE01	Connecticut Light & Power Company (CT DPUC)
Docket No. 19042-U	Savannah Electric & Power Company (Georgia PSC)
Docket No. 2004-178-E	South Carolina Electric & Gas Company (South Carolina PSC)
Docket No. 03-07-02	Connecticut Light & Power Company (CT DPUC)
Docket No. EX02060363,	
Phases I&II	Rockland Electric Company (NJ BPU)
Docket No. U-00-88	ENSTAR Natural Gas Company and Alaska Pipeline Company (Regulatory Commission of Alaska)
Phase I-2002 IERM,	
Docket No. U-02-075	Interior Telephone Company, Inc. (Regulatory Commission of Alaska)
Docket No. 05-SCNT-1048-AUD	South Central Telephone Company (Kansas CC)
Docket No. 05-TRCT-607-KSF	Tri-County Telephone Company (Kansas CC)
Docket No. 05-KOKT-060-AUD	Kan Okla Telephone Company (Kansas CC)
Docket No. 2002-747	Northland Telephone Company of Maine (Maine PUC)

Docket No. 2003-34	Sidney Telephone Company (Maine PUC)
Docket No. 2003-35	Maine Telephone Company (Maine PUC)
Docket No. 2003-36	China Telephone Company (Maine PUC)
Docket No. 2003-37	Standish Telephone Company (Maine PUC)
Docket Nos. U-04-022, U-04-023	Anchorage Water and Wastewater Utility (Regulatory Commission of Alaska)
Case 05-116-U/06-055-U	Entergy Arkansas, Inc. EFC (Arkansas Public Service Commission)
Case 04-137-U	Southwest Power Pool RTO (Arkansas Public Service Commission)
Case No. 7109/7160	Vermont Gas Systems (Department of Public Service)
Case No. ER-2006-0315	Empire District Electric Company (Missouri PSC)
Case No. ER-2006-0314	Kansas City Power & Light Company (Missouri PSC)
Docket No. U-05-043,44	Golden Heart Utilities/College Park Utilities (Regulatory Commission of Alaska)
A-122250F5000	Equitable Resources, Inc. and The Peoples Natural Gas Company, d/b/a Dominion Peoples (Pennsylvania PUC)
E-01345A-05-0816	Arizona Public Service Company (Arizona CC)
Docket No. 05-304	Delmarva Power & Light Company (Delaware PSC)
05-806-EL-UNC	Cincinnati Gas & Electric Company (Ohio PUC)
U-06-45	Anchorage Water Utility (Regulatory Commission of Alaska)
03-93-EL-ATA,	
06-1068-EL-UNC	Duke Energy Ohio (Ohio PUC)
PUE-2006-00065	Appalachian Power Company (Virginia Corporation Commission)
G-04204A-06-0463 et. al	UNS Gas, Inc. (Arizona CC)
U-06-134	Chugach Electric Association, Inc. (Regulatory Commission of Alaska)
Docket No. 2006-0386	Hawaiian Electric Company, Inc (Hawaii PUC)
E-01933A-07-0402	Tucson Electric Power Company (Arizona CC)
G-01551A-07-0504	Southwest Gas Corporation (Arizona CC)
Docket No. UE-072300	Puget Sound Energy, Inc. (Washington UTC)
PUE-2008-00009	Virginia-American Water Company (Virginia SCC)
PUE-2008-00046	Appalachian Power Company (Virginia SCC)
E-01345A-08-0172	Arizona Public Service Company (Arizona CC)
A-2008-2063737	Babcock & Brown Infrastructure Fund North America, LP. and The Peoples Natural Gas Company, d/b/a Dominion Peoples (Pennsylvania PUC)
08-1783-G-42T	Hope Gas, Inc., dba Dominion Hope (West Virginia PSC)
08-1761-G-PC	Hope Gas, Inc., dba Dominion Hope, Dominion Resources, Inc., and Peoples Hope Gas Companies (West Virginia PSC)
Docket No. 2008-0083	Hawaiian Electric Company, Inc. (Hawaii PUC)
Docket No. 2008-0266	Young Brothers, Limited (Hawaii PUC)
G-04024A-08-0571	UNS Gas, Inc. (Arizona CC)
Docket No. 09-29	Tidewater Utilities, Inc. (Delaware PSC)
Docket No. UE-090704	Puget Sound Energy, Inc. (Washington UTC)
09-0878-G-42T	Mountaineer Gas Company (West Virginia PSC)
2009-UA-0014	Mississippi Power Company (Mississippi PSC)
Docket No. 09-0319	Illinois-American Water Company (Illinois CC)
Docket No. 09-414	Delmarva Power & Light Company (Delaware PSC)
R-2009-2132019	Aqua Pennsylvania, Inc. (Pennsylvania PUC)
Docket Nos. U-09-069, U-09-070	ENSTAR Natural Gas Company (Regulatory Commission of Alaska)
Docket Nos. U-04-023, U-04-024	Anchorage Water and Wastewater Utility - Remand (Regulatory Commission of Alaska)
W-01303A-09-0343 & SW-01303A-09-0343	Arizona-American Water Company (Arizona CC)
09-872-EL-FAC & 09-873-EL-FAC	Financial Audits of the FAC of the Columbus Southern Power Company and the Ohio Power Company - Audit I (Ohio PUC)

2010-00036	Kentucky-American Water Company (Kentucky PSC)
E-04100A-09-0496	Southwest Transmission Cooperative, Inc. (Arizona CC)
E-01773A-09-0472	Arizona Electric Power Cooperative, Inc. (Arizona CC)
R-2010-2166208,	
R-2010-2166210,	
R-2010-2166212, &	
R-2010-2166214	Pennsylvania-American Water Company (Pennsylvania PUC)
PSC Docket No. 09-0602	Central Illinois Light Company D/B/A AmerenCILCO; Central Illinois Public Service Company D/B/A AmerenCIPS; Illinois Power Company D/B/A AmerenIP (Illinois CC)
10-0713-E-PC	Allegheny Power and FirstEnergy Corp. (West Virginia PSC)
Docket No. 31958	Georgia Power Company (Georgia PSC)
Docket No. 10-0467	Commonwealth Edison Company (Illinois CC)
PSC Docket No. 10-237	Delmarva Power & Light Company (Delaware PSC)
U-10-51	Cook Inlet Natural Gas Storage Alaska, LLC (Regulatory Commission of Alaska)
10-0699-E-42T	Appalachian Power Company and Wheeling Power Company (West Virginia PSC)
10-0920-W-42T	West Virginia-American Water Company (West Virginia PSC)
A.10-07-007	California-American Water Company (California PUC)
A-2010-2210326	TWP Acquisition (Pennsylvania PUC)
09-1012-EL-FAC	Financial, Management, and Performance Audit of the FAC for Dayton Power and Light – Audit I (Ohio PUC)
10-268-EL FAC et al.	Financial Audit of the FAC of the Columbus Southern Power Company and the Ohio Power Company – Audit II (Ohio PUC)
Docket No. 2010-0080	Hawaiian Electric Company, Inc. (Hawaii PUC)
G-01551A-10-0458	Southwest Gas Corporation (Arizona CC)
10-KCPE-415-RTS	Kansas City Power & Light Company – Remand (Kansas CC)
PUE-2011-00037	Virginia Appalachian Power Company (Commonwealth of Virginia SCC)
R-2011-2232243	Pennsylvania-American Water (Pennsylvania PUC)
U-11-100	Power Purchase Agreement between Chugach Association, Inc. and Fire Island Wind, LLC (Regulatory Commission of Alaska)
A.10-12-005	San Diego Gas & Electric Company (California PUC)
PSC Docket No. 11-207	Artesian Water Company, Inc. (Delaware PSC)
Cause No. 44022	Indiana-American Water Company, Inc. (Indiana Utility Regulatory Commission)
PSC Docket No. 10-247	Management Audit of Tidewater Utilities, Inc. Affiliate Transactions (Delaware Public Service Commission)
G-04204A-11-0158	UNS Gas, Inc. (Arizona Corporation Commission)
E-01345A-11-0224	Arizona Public Service Company (Arizona CC)
UE-111048 & UE-111049	Puget Sound Energy, Inc. (Washington Utilities and Transportation Commission)
Docket No. 11-0721	Commonwealth Edison Company (Illinois CC)
11AL-947E	Public Service Company of Colorado (Colorado PSC)
U-11-77 & U-11-78	Golden Heart Utilities, Inc. and College Utilities Corporation (The Regulatory Commission of Alaska)
Docket No. 11-0767	Illinois-American Water Company (Illinois CC)
PSC Docket No. 11-397	Tidewater Utilities, Inc. (Delaware PSC)
Cause No. 44075	Indiana Michigan Power Company (Indiana Utility Regulatory Commission)
Docket No. 12-0001	Ameren Illinois Company (Illinois CC)
11-5730-EL-FAC	Financial, Management, and Performance Audit of the FAC for Dayton Power and Light – Audit 2 (Ohio PUC)
PSC Docket No. 11-528	Delmarva Power & Light Company (Delaware PSC)
11-281-EL-FAC et al.	Financial Audit of the FAC of the Columbus Southern Power Company and the Ohio Power Company – Audit III (Ohio PUC)

Cause No. 43114-IGCC-4S1	Duke Energy Indiana, Inc. (Indiana Utility Regulatory Commission)
Docket No. 12-0293	Ameren Illinois Company (Illinois CC)
Docket No. 12-0321	Commonwealth Edison Company (Illinois CC)
12-02019 & 12-04005	Southwest Gas Corporation (Public Utilities Commission of Nevada)
Docket No. 2012-218-E	South Carolina Electric & Gas (South Carolina PSC)
Docket No. E-72, Sub 479	Dominion North Carolina Power (North Carolina Utilities Commission)
12-0511 & 12-0512	North Shore Gas Company and The Peoples Gas Light and Coke Company (Illinois CC)
E-01933A-12-0291	Tucson Electric Power Company (Arizona CC)
Case No. 9311	Potomac Electric Power Company (Maryland PSC)
Cause No. 43114-IGCC-10	Duke Energy Indiana, Inc. (Indiana Utility Regulatory Commission)
Docket No. 36498	Georgia Power Company (Georgia PSC)
Case No. 9316	Columbia Gas of Maryland, Inc. (Maryland PSC)
Docket No. 13-0192	Ameren Illinois Company (Illinois CC)
12-1649-W-42T	West Virginia-American Water Company (West Virginia PSC)
E-04204A-12-0504	UNS Electric, Inc. (Arizona CC)
PUE-2013-00020	Virginia and Electric Power Company (Virginia SCC)
R-2013-2355276	Pennsylvania-American Water Company (Pennsylvania PUC)
Formal Case No. 1103	Potomac Electric Power Company (District of Columbia PSC)
U-13-007	Chugach Electric Association, Inc. (The Regulatory Commission of Alaska)
12-2881-EL-FAC	Financial, Management, and Performance Audit of the FAC for Dayton Power and Light – Audit 3 (Ohio PUC)
Docket No. 36989	Georgia Power Company (Georgia PSC)
Cause No. 43114-IGCC-11	Duke Energy Indiana, Inc. (Indiana Utility Regulatory Commission)
UM 1633	Investigation into Treatment of Pension Costs in Utility Rates (Oregon PUC)
13-1892-EL FAC	Financial Audit of the FAC and AER of the Ohio Power Company – Audit I (Ohio PUC)
14-255-EL RDR	Regulatory Compliance Audit of the 2013 DIR of Ohio Power Company (Ohio PUC)
U-14-001	Chugach Electric Association, Inc. (The Regulatory Commission of Alaska)
U-14-002	Alaska Power Company (The Regulatory Commission of Alaska)
PUE-2014-00026	Virginia Appalachian Power Company (Commonwealth of Virginia SCC)
14-0117-EL-FAC	Financial, Management, and Performance Audit of the FAC and Purchased Power Rider for Dayton Power and Light – Audit 1 (Ohio PUC)
14-0702-E-42T	Monongahela Power Company and The Potomac Edison Company (West Virginia PSC)
Formal Case No. 1119	Merger of Exelon Corporation, Pepco Holdings, Inc., Potomac Electric Power Company, Exelon Energy Delivery Company, LLC, and New Special Purpose Entity, LLC (District of Columbia PSC)
R-2014-2428742	West Penn Power Company (Pennsylvania PUC)
R-2014-2428743	Pennsylvania Electric Company (Pennsylvania PUC)
R-2014-2428744	Pennsylvania Power Company (Pennsylvania PUC)
R-2014-2428745	Metropolitan Edison Company (Pennsylvania PUC)
Cause No. 43114-IGCC-12/13	Duke Energy Indiana, Inc. (Indiana Utility Regulatory Commission)
14-1152-E-42T	Appalachian Power Company and Wheeling Power Company (West Virginia PSC)
WS-01303A-14-0010	EPCOR Water Arizona, Inc. (Arizona CC)
2014-000396	Kentucky Power Company (Kentucky PSC)
15-03-45 ^A	Iberdrola, S.A. Et Al, and UIL Holdings Corporation merger (Connecticut PURA)
A.14-11-003	San Diego Gas & Electric Company (California PUC)
U-14-111	ENSTAR Natural Gas Company (Regulatory Commission of Alaska)
2015-UN-049	Atmos Energy Corporation (Mississippi PSC)
15-0003-G-42T	Mountaineer Gas Company (West Virginia PSC)

PUE-2015-00027	Virginia Electric and Power Company (Commonwealth of Virginia SCC)
Docket No. 2015-0022	Hawaiian Electric Company, Inc., Hawaii Electric Light Company, Inc., Maui Electric Company Limited, and NextEra Energy, Inc. (Hawaii PUC)
15-0676-W-42T	West Virginia-American Water Company (West Virginia PSC)
15-07-38^^	Iberdrola, S.A. Et Al, and UIL Holdings Corporation merger (Connecticut PURA)
15-26^^	Iberdrola, S.A. Et Al, and UIL Holdings Corporation merger (Massachusetts DPU)
15-042-EL-FAC	Management/Performance and Financial Audit of the FAC and Purchased Power Rider for Dayton Power and Light (Ohio PUC)
2015-UN-0080	Mississippi Power Company (Mississippi PSC)

* Testimony filed, examination not completed

** Issues stipulated

*** Company withdrew case

^ Testimony filed, case withdrawn after proposed decision issued

^^ Issues stipulated before testimony was filed

COMMISSIONERS
SUSAN BITTER SMITH – Chairman
BOB STUMP
BOB BURNS
DOUG LITTLE
TOM FORESE



ARIZONA CORPORATION COMMISSION

Attachment RCS-2
Docket Nos. W-01732A-15-0131 &
W-01303A-15-0131
Page 3 of 3
JOE BERICH
Executive Director

November 5, 2015

Timothy Sabo
Snell & Wilmer
One Arizona Center
400 East Van Buren Street, Suite 1900
Phoenix, AZ 85004

tsabo@swlaw.com

Re: Staff's Responses to Willow Valley Water Co., Inc.'s First Set of Data Requests to Staff
Docket No. W-01732A-15-0131

Dear Mr. Sabo:

Enclosed is Staff's Responses to Willow Valley Water Co., Inc.'s First Set of Data Requests to Staff.

Sincerely,

A handwritten signature in cursive script, appearing to read "R. R. Mitchell".

Robin R. Mitchell
Attorney, Legal Division
(602) 542-3402

RRM:mam
Enclosure

cc: Darron Carlson (Via Email Only)

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.1 Please provide all work papers associated with Staff's testimony.

RESPONSE: Sending under separate cover.

RESPONDENT: Darron Carlson

The Going Concern Principle

The going concern principle is the assumption that an entity will remain in business for the foreseeable future. Conversely, this means the entity will *not* be forced to halt operations and liquidate its assets in the near term at what may be very low fire-sale prices. By making this assumption, the accountant is justified in deferring the recognition of certain expenses until a later period, when the entity will presumably still be in business and using its assets in the most effective manner possible.

An entity is assumed to be a going concern in the absence of significant information to the contrary. An example of such contrary information is an entity's inability to meet its obligations as they come due without substantial asset sales or debt restructurings. If such were not the case, an entity would essentially be acquiring assets with the intention of closing its operations and reselling the assets to another party.

If the accountant believes that an entity may no longer be a going concern, then this brings up the issue of whether its assets are impaired, which may call for the write-down of their carrying amount to their liquidation value. Thus, the value of an entity that is assumed to be a going concern is higher than its breakup value, since a going concern can potentially continue to earn profits.

The going concern concept is not clearly defined anywhere in generally accepted accounting principles, and so is subject to a considerable amount of interpretation regarding when an entity should report it. However, generally accepted auditing standards (GAAS) *do* instruct an auditor regarding the consideration of an entity's ability to continue as a going concern.

The auditor evaluates an entity's ability to continue as a going concern for a period not greater than one year following the date of the financial statements being audited. The auditor considers (among other issues) the following items in deciding if there is a substantial doubt about an entity's ability to continue as a going concern:

- Negative trends in operating results, such as a series of losses

- Loan defaults by the company
- Denial of trade credit to the company by its suppliers
- Uneconomical long-term commitments to which the company is subjected
- Legal proceedings against the company

If there is an issue, the audit firm must qualify its the audit report with a statement about the problem.

It is possible for a company to mitigate an auditor's view of its going concern status by having a third party guarantee the debts of the business or agree to provide additional funds as needed. By doing so, the auditor is reasonably assured that the business will remain functional during the one-year period stipulated by GAAS.

Similar Terms

The going concern principle is also known as the *going concern concept*.

1. Staff should evaluate whether to support the transfer or just recommend against the acquisition premium and set forth some conditions. It is not in the public interest to reward companies with significant rate increase and a SIB only to have them do nothing to improve their operations.
 - a. Global's lack of action to further the public interest may be further compounded by yet unknown conditions that might be disclosed in a review of Epcor's due diligence workpapers and the review of the board minutes of both companies. (See 8 & 9 below).
 - b. Global's compliance filing of May 29, 2015 in 12-0309 et al indicates that very little has been done to reduce water loss in this and other systems.
 - c. Refusal to provide due diligence workpapers prevents Staff from verifying that any significant due diligence was performed.
 - d. Refusal to provide due diligence workpapers prevents Staff from evaluating any known detriments or benefits to ratepayers, as would be discussed in due diligence workpapers.
 - e. A recommendation against approving the transfer should be accompanied by Staff concerns about the filing and items to be considered in the event that the ACC does approve the transfer.
2. Prior rate case 12-0309 et al, Decision No. 74364, Willow Valley was awarded a rate increase of \$404,269, or 57.53%, a SIB, and a rate design heavily weighted with amounts from the monthly minimums.
 - a. None of this has resulted in any improvements such as SIB related or any other repairs. It appears that the rate increase has benefitted the company only.
 - b. Global had argued that SIB was necessary and would result in reductions to water loss but has failed to effect any repairs.
 - c. Any changes to the existing SIB as part of this case would represent changes to a previously approved SIB outside of a rate case.
3. The transfer of assets will result in a rate base supported by a capital structure / COE that would result in savings for the ratepayers. Epcor is not willing to share benefits with ratepayers. This would save ratepayers appx \$40K per year. In response to GWB 1.3, EWAZ touts rate stability as a benefit to ratepayers from the sale. "Rate Stability: EWAZ is not seeking, as part of this Application, to change any of the rates previously approved by

the Commission. This will limit customer confusion or concern regarding the new ownership structure in Willow Valley.”

4. Willow Valley is not a small troubled company, since its parent is well capitalized and has access to the financial markets.
5. GWB 1.10 is unresponsive. Operational concerns should be answered more fully with current information from Global instead of just sending in testimony from 2012 case. If Global does not want to answer, it's another reason to recommend denial.
6. Companies seek a 10% acquisition premium based on an overstated rate base. Slight discrepancy in response to GWB 1.3. Text of 1.3 states rate bases at \$2,268,031 while supporting schedule shows rate base of \$2,273,846, a difference of \$5,815. More important concern is that the rate base schedules submitted in response to GWB 1.6 shows current rate base of \$1,964,397. Significant different due to the exclusion of ADIT from the rate base used in the rate base used by the Companies in determining the sale price of \$2,494,834, meaning that the acquisition premium is more correctly stated at \$530,537 or 27 percent. The ADIT liability represents a reduction to rate base for taxes funded by rates but not yet remitted to the taxing entities. Failure to recognize the ADIT liability deprives ratepayers of the benefits for taxes already paid and funded through rates but not remitted by Global. Per response to GWB 1.6, the ADIT as of December 31, 2014 is \$260,224 which is an ADIT liability of \$293,862 net of an ADIT receivable of \$33,638. The Seller's rate base schedule 3.2 also includes \$19,767 for "Utility Plant Acquisition Adjustment" (not previously approved? And its inclusion in the current calculation effectively does approved it) and fails to include Customer Meter Deposits of \$31,898. The buyer will be responsible to refund Customer Meter Deposits as needed and it is unclear why these amounts should be excluded from the calculation. If meter deposits are not intended to transfer for purposes of calculating the sales price, the value of the meter deposits should be imputed for ratemaking purposes and for purposes of calculating the acquisition premium. Failure to recognize meter deposits also deprives ratepayers of the reduction to the price and in a rate case, fails to recognize the non-investor supplied capital.
7. GWB 1.11 Companies state that there are no employees directly employed by Willow and are employees of Global Water. Question is unresponsive in terms of other indirect employment and related costs and if the transfer will harm or help ratepayers.
8. Due Diligence workpapers – EWAZ objected to providing these. Staff is therefore unable to verify that any due diligence has been performed or to evaluate the scope of the review. Staff is further unable to determine whether any potential benefits or detriment to ratepayers are expected or anticipated.
9. Board of Directors minutes and presentations – Companies object to providing these. Staff is unable to confirm the support of either company's board. Staff is further unable to

determine whether any potential benefits or detriment to ratepayers are expected or anticipated.

Taxable asset acquisitions

Recurring issue

- Buyer's ratemaking treatment of seller's pre-disposition "regular" deferred tax liabilities in a taxable asset acquisition
 - Various transaction forms
- Federal income tax consequences
 - Seller's pre-disposition DTL reverses as a result of the taxable gain
 - Buyer re-sets DTLs to zero
- May the buyer reduce its rate base by the seller's pre-disposition deferred tax liability (DTL)
 - By an amount that happens to equal the seller's DTL? *NO*
 - May buyer reduces its revenue requirement by an amount that approximates the effect of seller's pre-acquisition DTL on its return? *NO*

Deferred tax consistency requirement Section 168(i)(9)(B)

- One way in which the basic normalization rule of Section 168(i)(9)(A) is not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of the basic normalization rule
 - Estimates or projections of:
 - Tax expense
 - Depreciation expense
 - Deferred tax liability
 - Rate base
- Must be used consistently for all elements

Number: **201541010**
Release Date: 10/9/2015
Index Number: 167.22-01

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact: _____, ID No. _____

Refer Reply To:
CC:PSI:B06
PLR-143241-14

Date:
July 06, 2015

Taxpayer	=
Parent	=
State A	=
State B	=
Commission A	=
Commission B	=
Commission C	=
Operator	=
Year A	=
Case A	=
Case B	=
Case C	=
Date X	=
Director	=

This letter responds to Parent's request, made on behalf of Taxpayer, dated January 9, 2015, for a ruling on the application of the normalization rules to certain regulatory procedures applied in State as described below.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is primarily engaged in the business of generating, transmitting, distributing, and selling electric power to customers in State A and State B. It is subject to regulation by Commission A, Commission B, and Commission C with respect to terms and conditions of services, including the rates it may charge for its services. All three Commissions establish Taxpayer's rates based on Taxpayer's costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

The law of State A provides a process under which a utility may recover its costs relating to projects such as new electric generation facilities as a stand-alone rate adjustment added to customers' base rates. As relevant to this ruling request, the process for setting the rates involves two components. First, a taxpayer files estimated projections of all factors, including Accumulated Deferred Federal Income Taxes (ADFIT), relevant to the costs associated with the facility that is the subject of the rate adjustment. Rate base for this purpose is calculated using an average of the thirteen projected end of month balances of the components of rate base. The rate adjustment computed using these projections goes into effect at the beginning of the test period. The test period is a twelve month period. The anticipated collections from rate payers, the actual cost incurred with respect to the generating facility and any differences between anticipated amounts and actual amounts are reconciled by a "true-up" mechanism at the end of the test year. Under this mechanism, the reconciliation amount is either charged to ratepayers (if actual revenues are below estimates) or credited to ratepayers (if actual revenues exceed estimates) as part of the rates established for the forthcoming rate year. For both under and over collections, a carrying charge is imposed.

Taxpayer owns and operates electric transmission lines in several states, including State A and State B. These lines are integrated into Operator, a regional transmission operator. The rates that Taxpayer may charge its customers for these transmission services are set using a formula approved by Commission C. The formula rates are calculated using a methodology similar to that used to calculate the rate adjustments, inasmuch as the formula rates are calculated using projected costs to establish rates during the period for which rates are being set and a true-up based on over or under recoveries that are reflected in a subsequent rate year. The rates are determined by application of the formula approved by Commission C and go into effect with no additional action by Commission C.

Taxpayer claims accelerated depreciation on its tax returns to the extent permitted by the Internal Revenue Code. Taxpayer normalizes the federal income taxes deferred as a result of its use of accelerated depreciation and thus maintains an ADFIT balance on its regulatory books. In ratemaking proceedings before Commission A to authorize rate adjustments as well as in calculation of the formula rates, rate base is reduced by the calculated ADFIT balance. In calculating its ADFIT balance for purposes of both the projection and true-up elements of the rate adjustment

calculations, Taxpayer followed the same averaging conventions it used for the other components of rate base. However, for prior formula rate filings, Taxpayer had calculated its ADFIT balance by an average of the beginning and ending balances notwithstanding that it used a 13-month average for computation of the plant portion of rate base. In those prior cases, the averages are calculated in accordance with the provisions of the Commission-approved template and the differences in averaging conventions are required by the regulations adopted by Commission C.

Section 1.167(l)-1(h)(6) of the Income Tax Regulations requires that a proration methodology be used by Taxpayer to calculate its applicable ADFIT balance for future test periods. Prior to Year A, Taxpayer had not used the proration methodology either in estimating its projected ADFIT balance or for the calculation of ADFIT for purposes of the true-up. Members of Taxpayer's tax department became concerned about the normalization implications of not using the proration formula during Year A. In filing Case A, Case B, and Case C, Taxpayer incorporated the proration methodology into the calculation of its projected ADFIT balance. In addition, Taxpayer incorporated the proration methodology into the calculation of the true-up in Case B. The staff of Commission A did not agree that the test period used for the rate adjustment ratemaking was a future test period and therefore asserted that the proration methodology was not required. In each of these cases, Commission A approved the use of the proration methodology in the projected ADFIT balance but denied its use in the true-up. When Commission A approved the use of the proration methodology for the projected ADFIT balance, it revised a portion of the Taxpayer's cash working capital allowance to reflect the adoption of the proration methodology. The adjusted portion was intended to compensate Taxpayer for the lag in time between when expenditures are made for services by Taxpayer and when collections for those services are received by Taxpayer. Commission A concluded that the item in the cash working capital allowance was duplicative of the effect of the proration methodology and was thus unnecessary. Due to the uncertainty surrounding the application of the proration methodology and the adjustment to cash working capital, Commission A directed Taxpayer to seek this ruling from the Internal Revenue Service.

Both Commission A and Commission C at all times have required that all public utilities under their respective jurisdictions use normalized methods of accounting.

Taxpayer requests that we rule as follows:

1. The proration methodology requirement does not apply to stand-alone rate adjustment ratemaking and to the Commission C formula rates even if they involve future test periods.
2. The estimated projection component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.

3. The true-up component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.
4. In Taxpayer's stand-alone rate adjustment proceedings, an adjustment to eliminate from the Taxpayer's cash working capital allowance any provision for accelerated depreciation-related ADFIT if the proration methodology is employed does not conflict with the normalization rules.
5. In order to comply with the consistency requirement of the normalization rules, it is not necessary that the Taxpayer use the same averaging convention it uses in computing the other elements of rate base in computing its ADFIT balance for purposes of the formula rates.
6. If the Service rules adversely with respect to Rulings 1, 2, or 3, above, any failure by Taxpayer to employ the proration methodology prior to the proceedings in Cases A, B, or C or the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules requiring sanctions for such violation.
7. In the event that the Service rules adversely with respect to Ruling 5, above, Taxpayer's failure to comply with the consistency requirement in connection with its formula rates prior to the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules.

Law and Analysis

Issues 1 and 2

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the

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meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 1.167(l)-1(h)(6) sets forth additional normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in section 1.167(l)-1(a)(1), the rules provided in section 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base

exclusion amount using projected data then it must use the formula provided in section 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in section 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) in resolving the timing issue has been questioned by its failure to define some key terms. Nowhere does this provision state what is meant by the terms "historical" and "future" in relation to the period for determining depreciation for ratemaking tax expense (the "test period"). One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization "in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of section 1.167(l)-1(h)(6)(ii) of the regulations is consistent with the purpose of normalization, which is to preserve for

regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on projected (future estimated) data is prorated according to the formula in section 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

There are two kinds of ratemaking at issue here, with identical components. For both the stand-alone rate adjustment and the formula rates, Taxpayer estimates the various components of rate base. Rates go into effect as of the beginning of the service year.¹ As such, the rates are in effect during the test year and the proration formula must be used. The addition of the true up increases the ultimate accuracy of the rates but does not convert a future test period into a historical test period as those terms are used in the normalization regulations. Therefore, Taxpayer is required to apply the proration formula in calculating accumulated deferred income taxes for purposes of calculating rate base.

Issue 3

¹ We note that, because Taxpayer is using estimated data for the test period, the test period at issue here constitutes a "future test period" under the first interpretation discussed above as well.

As discussed above, where a taxpayer computes its ratemaking tax expense and rate base exclusion amount using projected data then must use the proration formula provided in section 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in section 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

In contrast to the projections discussed above, the true-up component is determined by reference to a purely historical period and there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. In calculating the true-up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.

Issue 4

In Taxpayer's stand-alone rate adjustment proceedings, Commission A adjusted the already-approved cash working capital allowance specifically to mitigate the effect of the use of the proration methodology, finding the effects duplicative. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse). Here, Commission A adjusted the cash working capital allowance specifically to mitigate the effect of the application of the proration methodology. This is inconsistent with the normalization rules. We do not hold that the normalization rules require a similar type of cash working capital adjustment in all cases; we hold only that, where, as here, it is adjusted or removed in an attempt to mitigate the effects of the

application of the proration methodology or similar normalization rule, that adjustment or removal is not permitted under the normalization rules.

Issue 5

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is

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also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

In order to satisfy the requirements of §168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. Here, rate base, depreciation expense, and accumulated deferred income taxes are all calculated in consistent fashion – all are averaged over the same period. While there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and ADFIT on the other, for purposes of §168(i)(9)(B), it is sufficient that both are determined by averaging and both are determined over the same period of time. Thus, the calculation of average rate base and accumulated deferred income taxes as described above complies with the consistency requirement of §168(i)(9)(B).

Because of the conclusion reached above, Taxpayer's seventh issue is moot and will not be considered further.

Issue 6

Because the Service has ruled in Issue 1 and 2 that Taxpayer was required to use the proration formula applicable to future test periods for the projected revenue requirement, prospectively adhering to the Service's interpretation of § 1.167(l)-1(h)(6)(ii) require adjustments to conform to this ruling. Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered. Specifically, the current timing of Taxpayer's stand-alone rate adjustment filings with Commission A will accommodate all adjustments or corrections to any prior estimated projections or true-ups necessary to conform to the requirements of this ruling in rates having an effective date no later Date X, including Case A, Case B, and Case C. In addition, Taxpayer has already sought an order from Commission C to make the necessary changes to the rate templates, not simply unilaterally adjusting the calculations (or the manner in which the templates are completed) in the next annual projections or true-up adjustments. If Taxpayer must request these changes through a filing with Commission C, Taxpayer has represented that it will make a filing with Commission C to amend its formula rate template within six months of receipt of this ruling letter, requesting that Commission C apply a methodology in accordance with this letter using an effective date of the first month following the date of the filing made with Commission C. Following Commission C's order in that filing, Taxpayer will prospectively apply the methodology consistent with

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this letter approved by Commission C. Until Commission C acts on the filing, Taxpayer will continue to use the methodology described above.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit, Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Here, Taxpayer has received stand-alone rate adjustments from Commission A without application of the proration methodology as required. In addition, Taxpayer used a template approved by Commission C to calculate formula-based rates. Both Commission A and Commission C have, at all times, required that utilities under their respective jurisdictions use normalization methods of accounting. Taxpayer also intended at all times to comply with the normalization rules. As concluded above, Taxpayer was required to use the proration methodology in these ratemaking proceedings. However because Commissions A and C as well as Taxpayer at all times sought to comply, and because Taxpayer will take the corrective actions described above, it is not currently appropriate to apply the sanction of denial of accelerated depreciation to Taxpayer.

Conclusions

1. The proration methodology requirement applies to all future test periods.
2. The estimated projection component of both the stand-alone rate adjustment ratemaking and the formula rate does employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is required to use the proration methodology in order to comply with the normalization rules.
3. The true-up component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.
4. In Taxpayer's stand-alone rate adjustment proceedings, an adjustment to eliminate from the Taxpayer's cash working capital allowance any provision for accelerated depreciation-related ADFIT if the proration methodology is employed does conflict with the normalization rules.
5. In order to comply with the consistency requirement of the normalization rules, it is not necessary that the Taxpayer use the same averaging convention it uses in computing the other elements of rate base in computing its ADFIT balance for purposes of the formula rates.

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6. The Service rules adversely with respect to Rulings 1 and 2, above. Any failure by Taxpayer to employ the proration methodology prior to the proceedings in Cases A, B, or C or the effective date approved by Commission C for the requested modification of the formula rates was not a violation of the normalization rules requiring sanctions for such violation.
7. Because the Service rules favorably with respect to Ruling 5, above, Taxpayer's requested Ruling 7 is moot.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.2 Please identify the witness who will take Mr. Becker's place and provide their qualifications.

RESPONSE: Darron Carlson who is employed by the Utilities Division of the Commission as a Public Utilities Analyst Manager. He has been employed with the Utilities Division since September of 1991. He holds a Bachelor of Arts degree in both Accounting and Business Management from Northeastern Illinois University in Chicago, Illinois. He has participated in quite a number of seminars and workshops related to utility ratemaking, cost of capital, income taxes, and similar issues. These have been sponsored by organizations such as the National Association of Regulatory Commissioners ("NARUC"), Duke University, Florida State University, Michigan State University, New Mexico State University, and various other organizations.

RESPONDENT: Darron Carlson

Willow 1.3 Admit that EPCOR Water Arizona Inc. has the management capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: Staff has made no statement or indication that EPCOR is not capable.

RESPONDENT: Darron Carlson

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.4 Admit that EPCOR Water Arizona Inc. has the financial capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: See response to Willow 1.3.

RESPONDENT: Darron Carlson

Willow 1.5 Admit that Epcor Water Arizona Inc. has the technical capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: See response to Willow 1.3.

RESPONDENT: Darron Carlson

Willow 1.6 List each decision of the Arizona Corporation Commission, of which Staff is aware, where the Commission approved a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of Staff Witness Becker).

RESPONSE: Staff is not aware of any.

RESPONDENT: Darron Carlson

**STAFF'S RESPONSE TO THE FIRST SET OF DATA REQUESTS FROM
WILLOW VALLEY WATER COMPANY, INC.
DOCKET NOS. W-01732A-15-0131 AND W-01303A-15-0131
NOVEMBER 5, 2015**

Willow 1.7 To the knowledge of Commission Staff, list each prior docket where Arizona Corporation Commission Staff proposed a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of Staff Witness Becker).

RESPONSE: See response to Willow 1.6.

RESPONDENT: Darron Carlson

Willow 1.8 Admit that if a regulatory liability is created for ADIT (as proposed in the testimony of Staff Witness Becker), that EWAZ will be required to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(1)-1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RESPONSE: Staff has determined that its recommendation to create a regulatory liability to replace the ADIT balance may result in a violation of the IRS normalization rules and therefore withdrawal of this recommendation is under internal review.

RESPONDENT: Darron Carlson

Willow 1.9 Provide Staff's calculation of the ratepayer impact if EWAZ is forced to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(1)-1, (together, Depreciation Normalization Rules)].

RESPONSE: See response to Willow 1.8

RESPONDENT: Darron Carlson

Checkpoint Contents
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IRS Rulings & Releases
Private Letter Rulings & TAMs, FSAs, SCAs, CCAs, GCMs, AODs & Other FOIA Documents
Private Letter Rulings & Technical Advice Memoranda (1950 to Present)
1994
PLR/TAM 9447057 - 9447001
PLR 9447009 -- IRC Sec(s). 168(i)(10), 11/25/1994

Private Letter Rulings

**Private Letter Ruling 9447009, 11/25/1994, IRC Sec(s).
168(i)(10)**

UIL No. 0168.24-01

Headnote:

Reference(s): Code Sec. 168(i)(10);

A corporation acquired for cash all of the issued and outstanding stock of a regulated public utility that owns and operates a natural gas transmission pipeline in several states. Elections under section 338 were made by the seller and purchaser, and the purchase of the utility's stock is treated as a purchase of its assets for federal income tax purposes.

The utility is subject to the regulatory authority of the Federal Energy Regulatory Commission (FERC). In a recent announcement, FERC ordered its regulated public utilities to adopt FAS 109 for financial accounting and reporting to FERC. As of the date that the utility is required to adopt FAS 109, its account balances are historic and do not take into account its acquisition or the section 338 elections. As a result, the utility has proposed journal entries on its FERC books to reflect the section 338 elections and their effect on prior net operating losses and the depreciable cost basis of its assets. The first two proposed entries eliminate the deferred tax receivable relating to the utility's net operating losses and to reflect the differences in basis between the new basis and FERC basis. The third entry involves deferred amounts resulting from normalization of section 168 depreciation.

Before its acquisition, the utility's accumulated deferred federal income taxes (ADFIT) totaled a figure consisting of an amount relating to accelerated depreciation that was normalized and an amount relating to a change in tax rates brought about by the Tax Reform Act of 1986. FERC proposes to leave the

ADFIT on the books as a reduction of rate base, thereby not recognizing the deemed sale of the utility's assets.

The Service has ruled that for any period after the date of its acquisition, the utility will violate the normalization requirements of section 168(l)(9) if its rate base is reduced for the unamortized ADFIT attributable to accelerated depreciation on public utility property claimed before the acquisition date. The Service reasoned that after the application of reg. section 1.167(1)-1(h)(2)(i), the utility's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the Service said, the deferred tax reserve resulting from accelerated depreciation should be removed from the utility's books of account and not flowed through to its customers.

Citing reg. section 1.167(1)-1, the Service concluded that the proposed accounting entries that eliminate the deferred tax receivable relating to net operating losses of the utility and to reflect the differences in basis between the new basis and FERC basis have no effect on, and are outside the scope of, section 168(l)(9).

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Full Text:

Date: August 4, 1994

CC:DOM:P&SI : 6-TR-31-3141-93

In Re: Private Letter Ruling Request-Normalization

LEGEND:

Taxpayer = ***

Subsidiary = ***

Target = ***

Seller = ***

Acquisition Date = ***

x = ***


y = ***

z = ***


Dear ***

This is in response to your company's (Taxpayer) request, dated December 10, 1993, for a letter ruling on behalf of your Subsidiary that it will not fail to utilize a normalization method of accounting if it makes certain proposed entries on its regulated books of account. In Taxpayer's request, you stated that the proposed entries are being made to comply with the Statement of Financial Accounting Standards No. 109 issued by the Financial Accounting Standards Board (FAS109) and to satisfy the corresponding Federal Energy Regulatory Commission's (FERC) interpretation.

Taxpayer's representations included in its submission follow:

On the Acquisition Date Taxpayer acquired all the issued and outstanding stock of Target (now your Subsidiary) from Seller, Target's parent, for cash. Taxpayer and Seller made a timely joint election under  section 338(h)(10) of the Internal Revenue Code for Target. As a result, the purchase of Target's stock is treated as a purchase of Target's assets for federal income tax purposes.


Subsidiary owns and operates a natural gas transmission pipeline system located in several states, and is subject to the regulatory authority of FERC. In a recent announcement FERC ordered its regulated public utilities to adopt FAS 109 for financial accounting and reporting to FERC. As of the date that Subsidiary is required to adopt FAS 109, its account balances were historic and do not take into account Taxpayer's purchase of Target from Seller and the section 338 elections.


Subsidiary has proposed certain journal entries on its FERC books to reflect the section 338 elections and their effect on prior net operating losses and the depreciable cost basis of its assets. Taxpayer has asked us to rule whether those proposed entries would violate the normalization requirements of  section


168(f)(2) of the Code. The first two proposed entries eliminate the deferred tax receivable relating to net operating losses of Target and to reflect the differences in basis between the new basis and FERC basis. The third entry involves deferred amounts resulting from normalization of section 168 depreciation.



Prior to its acquisition by Taxpayer, the accumulated deferred federal income taxes (ADFIT) of Target totaled x dollars consisting of y dollars related to accelerated depreciation which was normalized and z dollars relating to the change in tax rates brought about by the Tax Reform Act of 1986. Taxpayer's submission states that the excess tax reserve will continue to be amortized using the Reverse South Georgia Method.

Taxpayer represents that FHRC proposes to leave the y dollars of ADFIT on the books as a reduction to rate base, thereby not recognizing the deemed sale of Target's assets.

 Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.


 Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.


Former  section 167(i) of the Code generally provided that public utilities were entitled to use accelerated methods of depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(i)(3)(G) in a manner consistent with that found in section 168(i)(9)(A).  Section 1.167(i)-1 of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A taxes, construction costs, or any other taxes and items.


Section 1.167(i)-1(h)(i)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(i)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the tax year in which the different methods of depreciation are used.

Section 1.167(l)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes shall not be reduced except to reflect the amount for any tax year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

 Section 338(a) of the Code provides that, if the stock of a corporation ("target corporation") is acquired by another corporation ("purchasing corporation") in a qualified stock purchase, the purchasing corporation may elect to have the purchase of the target corporation's stock treated as if the target corporation sold all of its assets (as "old target") at the close of the acquisition date at fair market value in a single transaction. The target corporation then is treated as a new corporation that purchased those same assets (as "new target") as of the beginning of the day after the acquisition date.


If, before the stock purchase, the target corporation is a member of an affiliated group that files a consolidated return for the tax year within which the transaction takes place,  section 338(h)(10) of the Code provides an election under which tax liability of the target corporation from the deemed sale of its assets is included in the consolidated return of the selling consolidated group ("selling group"). This election is made jointly by the purchasing corporation and the selling group pursuant to section 1.338(h)(10)-1T(d)(1) of the temporary Income Tax Regulations.


The consequences of a section 338(h)(10) election are provided in section 1.338(h)(10)-1T(e) of the temporary regulations. Under section 1.338(h)(10)-1T(e)(1), old target recognizes gain or loss as if, while a member of the selling group, it sold all of its assets in a single transaction as of the close of the acquisition date. Section 1.338(h)(10)-1T(e)(3) further provides that, at the close of the acquisition date but after the deemed sale of assets, old target is treated as if it distributed all of its assets in a complete liquidation to which  section 332 of the Code applies. Thus, the primary effect of a section 338(h)(10) election is a deemed taxable sale by target corporation of all its assets followed by a deemed complete liquidation under section 332.




In addition, section 1.338(h)(10)-1T(e)(2) of the temporary regulations provides that, for purposes of chapter 1 of the Code, gain or loss is ignored on the actual sale or exchange by the selling group to the purchasing corporation of target corporation's stock included in a qualified stock purchase.


As to the consequences of a section 338(h)(10) election on new target, section 1.338(h)(10)-1T(e)(6) of the temporary regulations determines the adjusted gross-up basis ("AGUB") for target corporation. The AGUB is the total amount for which new target is deemed to have purchased all of its assets. The AGUB is allocated among the assets of new target.

In general, the AGUB is the sum of (1) the purchasing corporation's grossed-up basis in recently

purchased stock of target corporation, (2) the basis of the purchasing corporation's nonrecently purchased stock of target corporation, (3) the liabilities of new target as of the beginning of the day after the acquisition date (other than liabilities that were not liabilities of old target), and (4) other relevant items. Under  section 338(b)(4) of the Code and section 1.338-4T(j)(2) of the temporary regulations, the purchasing Corporation's grossed-up basis of recently purchased stock of target corporation is the basis of the purchasing corporation in recently purchased stock of target corporation, multiplied by a fraction whose numerator is 100 percent minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock and whose denominator is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.

Section 1.338-4T(j)(2) of the temporary regulations provides that new target generally is permitted to take depreciation deductions under  section 168 of the Code on depreciable property acquired in the deemed purchase of assets and may make new elections under section 168 without regard to the elections made by old target. For purposes of the anti-churning rule of section 168(f)(5) (formerly section 168(e)(4)) and the rule in section 168(i)(7) (formerly section 168(f)(10)), under which the transferee of property is treated as the transferor in certain cases, old target is not a related person with respect to new target. Consequently, the accelerated depreciation deduction attributable to old target's (Target) public utility property does not carryover to new target (Subsidiary). The ADFIT related to that property do not follow the assets.

Whether or not a taxpayer is in compliance with FAS109 or FERC accounting is a consideration independent of the consideration whether the normalization rules of  section 168 of the Code are satisfied. Fundamental in  section 168(i)(9) of the Code and section 1.167(i)-1(a) of the regulations is that there is sufficient deferral of federal income tax liability due to use of section 168 depreciation on depreciable property owned by the taxpayer. Thus, the proposed accounting entries that eliminate the deferred tax receivable relating to net operating losses of Target and to reflect the differences in basis between the new basis and FERC basis have no effect on and are outside the scope of  section 168(i)(9) of the Code. See section 1.167(i)-1 of the regulations.

Regarding the treatment of ADFIT, Taxpayer purchased all the stock of Target (Subsidiary) and Taxpayer and Seller made a joint election under  section 338(h)(10) of the Code for Target (Subsidiary). As a result of this election, the transaction is treated for federal income tax purposes as a sale of Target's assets by Target (as old target) to itself (as new target, or Subsidiary) in a taxable transaction. Because of this sale, Target's deferred tax reserve relating to accelerated depreciation is reduced under section 1.167(i)-1(h)(2)(i) of the regulations to reflect the retirements of Target's assets. After the application of section 1.167(i)-1(h)(2)(i), Target's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the deferred tax reserve resulting from accelerated depreciation should be removed from Target's regulated books of account and not flowed through to the customers of subsidiary. For any

period subsequent to Acquisition Date, Subsidiary will violate the normalization requirements of section 188(i)(9) if Subsidiary's rate base is reduced for the unamortized ADFIT attributable to accelerated depreciation on public utility property claimed before Acquisition Date.

No opinion is expressed regarding any Code section other than set out above. Further, no opinion is expressed regarding any amount in the excess tax reserve resulting from the change in federal tax rates. The taxpayer should be sure to elect to apply the final regulations under section 338 retroactively to the transaction in the manner prescribed in section 1.338(i)-1.

This ruling is directed only to the taxpayer who requested it.  Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

HAROLD E. BURGHART

Assistant to the Chief, Br. 6

Office of Assistant Chief Counsel (Passthroughs and Special Industries)

Enclosures (2) Copy of his letter Copy for section 6110 purposes

Checkpoint Contents

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Private Letter Rulings & Technical Advice Memoranda (1950 to Present)

1994

PLR/TAM 9418034 - 9418001

PLR 9418004 – IRC Sec(s). 46, 01/14/1994

Private Letter Rulings

Private Letter Ruling 9418004, 01/14/1994, IRC Sec(s). 46

UIL No. 0046.06-07; 0168.24-01

Headnote:

Section 46 -- Investment Credit Amount

Reference(s): Code Sec. 46;

A regulated public utility company provides telecommunications service through local exchange telephone operations. The company acquired, subject to a section 338(H) election, all of the stock of an unrelated public utility company (Sub). Before the acquisition, Sub claimed investment credits and accelerated depreciation deductions on its public utility property.

The Service has ruled that for any period after the acquisition, Sub will violate the normalization requirements of section 46(f) if its cost of service is reduced for the amortization of any portion of the unamortized and unrecaptured accumulated deferred investment tax credits (ADITCs) attributable to investment credits on public utility property claimed before the acquisition. A transfer of an equity account of Sub of unamortized ADITCs attributable to public utility property claimed before the acquisition will not violate the normalization requirements, the Service ruled. The Service also ruled that Sub will violate the normalization rules of section 168(i) if its rate base is reduced for unamortized accumulated deferred federal income taxes attributable to accelerated depreciation on public property claimed before the acquisition date.

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Full Text:

Date: January 14, 1994

In re: Private Letter Ruling Request on
Normalization of Investment Credits
and Accelerated Depreciation

LEGEND:

Taxpayer = ***

Target = ***

Seller = ***

Commission A = ***


Commission B = ***

Acquisition Date = ***

y dollars = ***

x dollars = ***

Dear ***

This letter responds to your representative's letter of July 8, 1993, requesting rulings by Taxpayer on behalf of Target with respect to the proper treatment of Target's accumulated deferred investment tax credits ("ADITC's") under  section 46(f)(2) of the Internal Revenue Code and accumulated deferred federal income taxes ("ADFIT's") under section 168(i)(9), subsequent to an election under section 338(h)(10).

Taxpayer represents that the facts are as follows:


Taxpayer is the parent company of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting. Taxpayer is a regulated public utility company engaged in the business of providing telecommunications services through local exchange telephone operations and mobile cellular communications operations.

On Acquisition Date, Taxpayer acquired all of the common stock of Target from Seller, an unrelated communications company. Following the acquisition, Target will join in the filing of the consolidated federal income tax return of Taxpayer. Target is a public utility engaged in the business of providing telephone services and is subject to regulation by Commission A and Commission B.




[Taxpayer and Seller made a timely joint election under  section 338(h)(10) of the Code for Target. As]

a result, the purchase of Target's stock is treated as a purchase of Target's assets for federal income tax purposes.


For financial and regulatory purposes, the basis of Target's assets after the stock purchase will have the same basis as Target had prior to the stock purchase.


Before Acquisition Date, Target had claimed both investment credits and accelerated depreciation deductions on its public utility property. For purposes of the investment credit normalization rules under  section 46(f) of the Code, Target has elected to be treated under section 46(f)(2). At the time of the acquisition, Target had recorded on its books ADITC's totalling x dollars (net of recapture resulting from the section 338(h)(10) election) and ADFIT's totalling y dollars attributable to public utility property.

Because Taxpayer is concerned about the effect of a section 338(h)(10) election on the proper treatment of the x dollars in the ADITC account and the y dollars in the ADFIT account under the provisions of sections 46(f)(2) and 168(i)(9) of the Code, respectively, Taxpayer seeks the following rulings:


1. For any period subsequent to Acquisition Date, whether a reduction to Target's tax expense used to determine cost of service for ratemaking purposes for unamortized and unrecaptured ADITC attributable to investment credits on public utility property claimed before Acquisition Date would violate the provisions of  section 46(f)(2) of the Code?
2. Whether the transfer of the unamortized and unrecaptured ADITC to an equity account of Target would violate the normalization requirements of  section 46(f)(2) of the Code?
3. For any period subsequent to Acquisition Date, whether a reduction to Target's rate base for ADFIT attributable to accelerated depreciation on public utility property claimed prior to Acquisition Date would violate the provisions of  section 168(i)(9) of the Code?

Taxpayer's ruling requests depend upon the effect of a section 338(h)(10) election on the investment credits and accelerated depreciation deductions associated with Target's public utility property.


 Section 338(a) of the Code provides that, if the stock of a corporation ("target corporation") is acquired by another corporation ("purchasing corporation") in a qualified stock purchase, the purchasing corporation may elect to have the purchase of the target corporation's stock treated as if the target corporation sold all of its assets (as "old target") at the close of the acquisition date at fair market value in a single transaction. The target corporation then is treated as a new corporation that purchased those same assets (as "new target") as of the beginning of the day after the acquisition date.

If, before the stock purchase, the target corporation is a member of an affiliated group that files a consolidated return for the tax year within which the transaction takes place,  section 338(h)(10) of the


Code provides an election under which recapture and other tax liability of the target corporation from the deemed sale of its assets is included in the consolidated return of the selling consolidated group ("selling group"). This election is made jointly by the purchasing corporation and the selling group pursuant to section 1.338(h)(10)-1T(d)(1) of the temporary Income Tax Regulations.

The consequences of a section 338(h)(10) election are provided in section 1.338(h)(10)-1T(e) of the temporary regulations. Under section 1.338(h)(10)-1T(e)(1), old target recognizes gain or loss as if, while a member of the selling group, it sold all of its assets in a single transaction as of the close of the acquisition date. Section 1.338(h)(10)-1T(e)(3) further provides that, at the close of the acquisition date but after the deemed sale of assets, old target is treated as if it distributed all of its assets in a complete liquidation to which  section 332 of the Code applies. Thus, the primary effect of a section 338(h)(10) election is a deemed taxable sale by target corporation of all its assets followed by a deemed complete liquidation under section 332.


In addition, section 1.338(h)(10)-1T(e)(2) of the temporary regulations provides that, for purposes of Chapter 1 of the Code, gain or loss is ignored on the actual sale or exchange by the selling group to the purchasing corporation of target corporation's stock included in a qualified stock purchase.


Under section 1.338(h)(10)-1T(e)(7)(ii), any investment credit property deemed sold by old target on the close of the acquisition date may be subject to recapture under  section 47(a) of the Code. Any increase in tax resulting from the recapture of old target's investment credit is added to the tax liability of the selling group for the tax period that includes the acquisition date.


As to the consequences of a section 338(h)(10) election on new target, section 1.338(h)(10)-1T(e)(6) of the temporary regulations determines the adjusted gross-up basis ("AGUB") for target corporation. The AGUB is the total amount for which net target is deemed to have purchased all of its assets. The AGUB is allocated among the assets of new target.

In general, the AGUB is the sum of (1) the purchasing corporation's grossed-up basis in recently purchased stock of target corporation, (2) the basis of the purchasing corporation's nonrecently purchased stock of target corporation, (3) the liabilities of new target as of the beginning of the day after the acquisition date (other than liabilities that were not liabilities of old target), and (4) other relevant items. Under  section 338(b)(4) of the Code and section 1.338-4T(j)(2) of the temporary regulations, the purchasing corporation's grossed-up basis of recently purchased stock of target corporation is the basis of the purchasing corporation in recently purchased stock of target corporation, multiplied by a fraction whose numerator is 100 percent minus the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's nonrecently purchased stock and whose denominator is the percentage of stock (by value) in the target corporation attributable to the purchasing corporation's recently purchased stock.


In addition, section 1.338(h)(10)-1T(e)(8)(ii) of the temporary regulations provides that section 1.338-4T(l), which covers certain matters affecting new target, is applicable to a section 338(h)(10) election. In

accordance with section 1.338-4T(1)(2), new target is entitled to the investment credit for property it is deemed to purchase under  section 338 of the Code, provided the property would qualify for the investment credit if new target acquired it in an actual purchase.


Further, section 1.338-4T(1)(2) of the temporary regulations provides that new target generally is permitted to take depreciation deductions under  section 168 of the Code on depreciable property acquired in the deemed purchase of assets and may make new elections under section 168 without regard to the elections made by old target. For purposes of the anti-churning rule of section 168(f)(5) (former section 168(e)(4)) and the rule in section 168(i)(7) (former section 168(f)(10)) under which the transferee of property is treated as the transferor in certain cases, old target is not a related person with respect to new target.

In the present situation, Taxpayer purchased all of the common stock of Target, and Taxpayer and Seller made a joint election under  section 338(h)(10) of the Code for Target. This election results, for federal income tax purposes, in a deemed taxable sale of assets by Target (as "old Target") in a single transaction as of the close of Acquisition Date. Consequently, gain or loss on this deemed sale is recognized by old Target, and any unearned investment credits of old Target are recaptured.

Further, Target is treated as a new corporation that purchased those same assets (as "new Target") on the day after Acquisition Date. The basis of old Target's assets do not carryover to new Target. Instead, new Target receives a new tax basis in the assets deemed purchased from old Target. Because the anti-churning rules of section 168(f)(5) and the transferor-transferee rules under section 168(i)(7) do not apply to new Target, it does not "step into the shoes" of old Target for depreciation purposes. Therefore, new Target is entitled to deduct depreciation on the new tax basis and receives the benefit of a new placed in service date for the assets deemed purchased. Moreover, new Target is entitled to claim investment credit, if available, on the new tax basis.

Thus, as a result of the section 338(h)(10) election, the purchase of Target's stock by Taxpayer is treated for federal income tax purposes as a purchase of Target's assets in a taxable transaction. Consequently, the investment credits and accelerated depreciation deductions attributed to old Target's public utility property do not carryover from old Target to new Target. Thus, the ADITC's of x dollars and the ADFIT's of y dollars related to that property do not follow the assets. 

Issue NO. 1

Target has elected to account for the investment credit on public utility property in accordance with  section 46(f)(2) of the Code. This section provides that no investment credit determined under section 46(a) shall be allowed by section 38 with respect to any public utility property of the taxpayer (a) if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the investment credit, or (b) if the base to which the taxpayer's rate of

return for ratemaking purposes is applied is reduced by reason of any portion of the investment credit.

Section 1.46-6(a)(3) of the regulations provides that the provisions of section 46(f)(2) of the Code are limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayer's regulated books of account only. If an election is made under section 46(f)(2), the credit may be flowed through to income, but not more rapidly than ratably, and there may not be any reduction in rate base.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Under section 1.46-6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense" means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.


Section 46(f)(7) of the Code provides that if by reason of a corporate reorganization or by reason of any other acquisition of the assets of one taxpayer by another taxpayer, the application of any provisions of section 46(f) to any public utility property does not carry out the purposes of section 46(f), the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of section 46(f).


According to section 46(f)(10)(A) of the Code, one way in which the requirements of section 46(f)(2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under section 46(f)(10)(B), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's qualified investment for purposes of the investment credit allowable by section 38 unless such estimate or projection is also used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.


Any public utility that claims the investment credit for public utility property must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. Under normalization accounting, the immediate flow-through of the investment credit for public utility property to the utility's customers is prohibited. Instead, under section 46(f)(2) of the Code, for ratemaking purposes the utility defers the investment credit it clarified for Federal income tax purposes and then amortizes the deferred balance ratably over the regulatory life of the assets generating the credit.


Taxpayer's first ruling request involves the treatment of the ADITC's not subject to recapture upon the deemed sale of Target's public utility property under a section 338(h)(10) election.

In a taxable sale of assets, the purchaser does not "step into the shoes" of the seller and as a result, any investment credit associated with the assets do not carryover from the seller to the purchaser. Instead, the purchaser receives the benefit of a new tax basis in, and a new placed in service date for, the property. This new basis and placed in service date determine the availability and the amount of the investment credit that the purchaser may claim for the acquired property. Except for certain transition property, property placed in service by a taxpayer after 1985 is not eligible for the investment credit.

In the present situation, Taxpayer acquired the common stock of Target, and Taxpayer and Seller made a joint election under  section 338(h)(10) of the Code for Target. This election results, for federal income tax purposes, in a deemed taxable sale of assets by old Target to new Target. New Target does not step into the shoes of old Target. Instead, new Target receives a new tax basis in, and a new placed in service date for, the assets deemed purchased from old Target. Consequently, the unamortized and unrecaptured ADITC's associated with old Target's public utility property do not follow the property. Thus, these ADITC's are not available to new Target for flow through to its customers.


Further, new Target is not entitled to claim the investment credit for the property deemed purchased from old Target because the property is placed in service by new Target after 1985. Therefore, for such property, there is no investment credit claimed by new Target to reduce cost of service under  section 46(f)(2) of the Code.



The normalization rules under  section 46(f) of the Code contemplate that the utility may claim the investment credit for public utility property. Further, the legislative purpose underlying section 46(f) was to provide capital for investment in new equipment. If the ADITC's related to old Target's public utility property are ratably flowed through to cost of service, new Target would be flowing through to its customers an investment credit that is not available to, and was not claimed by, it. Consequently, new Target would receive no tax benefits of the investment credit while its customers would. Accordingly, an adjustment to cost of service for the ADITC's of old Target would not be consistent with the purposes of section 46(f).

Further, the adjustment to cost of service for the ADITC's associated with old Target's public utility property would violate the consistency rules under  section 46(f)(10) of the Code. Such an adjustment assumes that the qualified investment of new Target for purposes of the investment credit allowable under section 38 is equal to old Target's qualified investment. However, section 46(f)(10)(B) clearly states that the TAXPAYER'S qualified investment must be used. In the present situation, the taxpayer is new Target. Because the investment credit has been repealed, none of the public utility property placed in service by new Target is eligible for the credit and consequently, its qualified investment is zero. Thus, an adjustment to the cost of service of new Target for the ADITC's of old Target would violate the normalization requirements of section 46(f)(2).

Issue NO. 2


Taxpayer's second ruling request relates to the transfer of the unamortized and unrecaptured ADITC's of x dollars to an equity account of Target. The effect of this accounting treatment is to flow through old Target's investment credit immediately to new Target's shareholder who is Taxpayer.


The normalization rules of  section 46(f)(2) of the Code do not require public utility commissions to take investment credit on public utility property into account in determining cost of service, but does permit them to do so provided the reduction to cost of service is by no more than a ratable portion of the credit.


As determined under this ruling, the flow through of the unamortized and unrecaptured ADITC's of old Target to new Target's customers would violate the normalization requirements of  section 46(f)(2) of the Code. By transferring the ADITC's of old Target to an equity account of new Target, this transferred amount will not be available to reduce cost of service and rate base in setting future rates and, as a result, the ADITC's of old Target would not be flowed through to new Target's customers. Thus, the normalization requirements of  section 46(f)(2) of the Code are satisfied. The fact that the accounting for the ADITC's of old Target will be for the benefit of Target's shareholder who is Taxpayer is outside the scope of section 46(f).

Issue NO. 3

Taxpayer's third ruling request involves the treatment of the unamortized ADFIT's upon the deemed sale of Target's public utility property under a section 338(h)(10) election.

 Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting,  section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

 Section 167(l) of the Code generally provides that public utilities are entitled to use accelerated

methods of depreciation if they use a "normalization method of accounting." A normalization method of accounting is defined in section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A).

Section 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property pursuant to section 167(l) of the Code should reflect the total amount of the deferral of Federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) of the regulations provides that the amount of Federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used.


Section 1.167(l)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes under section 167(l) of the Code shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

An election under section 338(h)(10) of the Code results in the sale of assets by old Target to new Target and the recognition of gain or loss upon such sale by old Target. Because of this sale, old Target's deferred tax reserve relating to accelerated depreciation is reduced under section 1.167(l)-1(h)(2)(i) of the regulations to reflect the retirements of old Target's assets. After the application of section 1.167(l)-1(h)(2)(i), old Target's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the deferred tax reserve resulting from accelerated depreciation should be removed from old Target's regulated books of account and not flowed through to the customers of new Target.


Based on Taxpayer's representations and the analysis as set forth above, we conclude as follows:

1. For any period subsequent to Acquisition Date, Target will violate the normalization requirements of section 46(f)(2) of the Code if Target's cost of service is reduced for the amortization of any portion of the unamortized and unrecaptured ADITC's attributable to investment credits on public utility property claimed before Acquisition Date.
2. The transfer to an equity account of Target of the unamortized and unrecaptured ADITC's attributable to investment credits on public utility property claimed before Acquisition Date will not violate the

normalization requirements of  section 46(f)(2) of the Code.

3. The unamortized ADFIT's related to accelerated depreciation on public utility property claimed by Target prior to Acquisition Date are eliminated upon the deemed sale of Target's assets under  section 338(h)(10) of the Code. Thus, for any period subsequent to Acquisition Date, Target will violate the normalization requirements of section 168(l)(9) if Target's rate base is reduced for the unamortized ADFIT's attributable to accelerated depreciation on public utility property claimed before Acquisition Date.

No opinion is expressed concerning whether the section 338(h)(10) election made by Taxpayer and Seller for Target is a valid election.

This ruling is directed only to the taxpayer who requested it.  Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of Assistant Chief

Counsel

(Passthroughs and Special

Industries)

Enclosures (2)

copy of this letter

copy for section 6110 purposes

fringe benefits



Attachment RCS-5
Docket Nos. W-01732A-15-0131 &
W-01303A-15-0131

Page 1 of 34

17 North Second Street
12th Floor
Harrisburg, PA 17101-1601
717-731-1970 Main
717-731-1985 Fax
www.postschell.com

Michael W. Gang

mwwgang@postschell.com
717-612-6026 Direct
717-731-1985 Fax
File #: 3283/138828

September 4, 2009

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street – Filing Room (2nd Floor)
PO Box 3265
Harrisburg, PA 17105-3265

RE: Joint Application for All of the Authority and the Necessary Certificate(s) of Public Convenience to Transfer All of the Issued and Outstanding Shares of Capital Stock of The Peoples Natural Gas Company, d/b/a Dominion Peoples, currently owned by Dominion Resources, Inc., to Peoples Hope Gas Companies LLC, an indirect subsidiary of Babcock & Brown Infrastructure Fund North America LP, and to Approve the Resulting Change in Control of The Peoples Natural Gas Company, d/b/a Dominion Peoples; Docket No. A-2008-2063737; JOINT PETITION FOR APPROVAL OF SETTLEMENT BETWEEN PEOPLES HOPE GAS COMPANIES LLC, THE PEOPLES NATURAL GAS COMPANY d/b/a DOMINION PEOPLES, DOMINION RESOURCES, INC., OFFICE OF CONSUMER ADVOCATE, AND OFFICE OF SMALL BUSINESS ADVOCATE

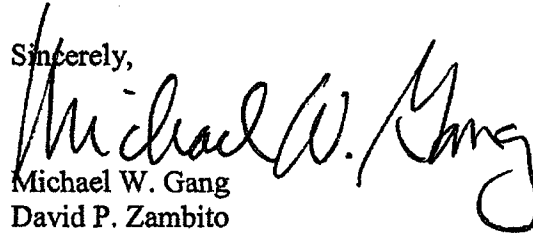
Dear Secretary McNulty:

Enclosed for filing with the Commission are an original and three (3) copies of the Joint Petition for Approval of Settlement between Peoples Hope Gas Companies LLC, The Peoples Natural Gas Company d/b/a Dominion Peoples, Dominion Resources, Inc., Office of Consumer Advocate, and Office of Small Business Advocate in the above-referenced proceeding. Copies of this Joint Petition have been served upon Administrative Law Judge Robert P. Meehan and upon the parties as indicated on the attached Certificate of Service.

If you have any questions regarding this filing, please direct them to me. Please date-stamp the extra copy and return it with our messenger. Thank you for your attention to this matter.

James J. McNulty, Secretary
September 4, 2009
Page 2

Sincerely,

A handwritten signature in black ink, appearing to read "Michael W. Gang". The signature is fluid and cursive, with the first name "Michael" being the most prominent.

Michael W. Gang
David P. Zambito
Counsel for
Peoples Hope Natural Gas Companies LLC

MGW/DPZ/kmg

Enclosures

cc: Honorable Robert P. Meehan
Per Certificate of Service
Scott J. Rubin, Esquire

CERTIFICATE OF SERVICE
Docket No. A-2008-2063737

I hereby certify that true and correct copies of the foregoing Joint Petition for Approval of Settlement between Peoples Hope Gas Companies LLC, The Peoples Natural Gas Company d/b/a Dominion Peoples, Dominion Resources, Inc., Office of Consumer Advocate, and Office of Small Business Advocate, have been served upon the parties, listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party).

VIA ELECTRONIC AND FIRST CLASS MAIL

Shaun A. Sparks, Esquire
Jennedy S. Johnson, Esquire
Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101-1923

Johnnie E. Simms, Esquire
Allison C. Kaster, Esquire
Office of Trial Staff
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street – 2 West
PO Box 3265
Harrisburg, PA 17105-3265

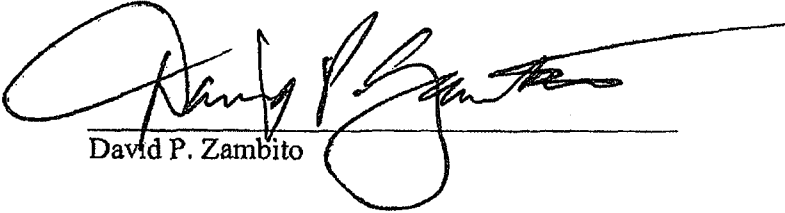
Lauren M. Lepkoski, Esquire
Sharon Webb, Esquire
Office of Small Business Advocate
Commerce Building, Suite 1102
300 North Second Street
Harrisburg, PA 17101-1303

William T. Hawke, Esquire
Janet L Miller, Esquire
Tori L. Geisler, Esquire
Hawke McKeon & Sniscak LLP
100 N. 10th Street
P. O. Box 1778
Harrisburg, PA 17105-1778

Susan G. George, Esquire
Deputy General Counsel
Gas Distribution & Retail
Dominion Resources Services, Inc.
D. L. Clark Bldg., Suite 500
501 Martindale Street
Pittsburgh, PA 15212-5835

John F. Povilaitis, Esquire
Ryan, Russell, Ogden & Seltzer, P.C.
800 North Third Street, Suite 101
Harrisburg, PA 17101

DATED: September 4, 2009


David P. Zambito

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Administrative Law Judge Robert P. Meehan

Joint Application for All of the Authority and the :
Necessary Certificate(s) of Public Convenience to :
Transfer All of the Issued and Outstanding Shares of :
Capital Stock of The Peoples Natural Gas Company, :
d/b/a Dominion Peoples, currently owned by :
Dominion Resources, Inc., to Peoples Hope Gas : Docket No. A-2008-2063737
Companies LLC, an indirect subsidiary of Babcock :
& Brown Infrastructure Fund North America, LP, :
and to Approve the Resulting Change in Control of :
The Peoples Natural Gas Company, d/b/a Peoples :

**JOINT PETITION FOR APPROVAL OF SETTLEMENT BETWEEN
PEOPLES HOPE GAS COMPANIES LLC,
THE PEOPLES NATURAL GAS COMPANY d/b/a DOMINION PEOPLES,
DOMINION RESOURCES, INC.,
OFFICE OF CONSUMER ADVOCATE, AND
OFFICE OF SMALL BUSINESS ADVOCATE**

Peoples Hope Gas Companies LLC (an indirect subsidiary of SteelRiver Infrastructure Fund North America LP (f/k/a Babcock & Brown Infrastructure Fund North America LP) (hereinafter "SteelRiver")) (hereinafter "PH Gas" or the "Company"),¹ The Peoples Natural Gas Company, d/b/a Dominion Peoples (currently owned by Dominion Resources, Inc. (hereinafter

¹ PH Gas is wholly-owned by LDC Holdings LLC, which is wholly owned by LDC Funding LLC, which in turn is wholly owned by SteelRiver.

"Dominion")) (hereinafter "PNGC"),² Dominion, the Office of Consumer Advocate (hereinafter "OCA"), and the Office of Small Business Advocate (hereinafter "OSBA")³ hereby submit this "Joint Petition for Approval of Settlement" ("Joint Petition") and respectfully request that Administrative Law Judge Robert P. Meehan recommend approval of, and the Commission approve, the above-captioned Joint Application consistent with the terms and conditions set forth in this Joint Petition.⁴ This Joint Petition represents a full settlement of all issues between the Signatory Parties in the instant proceeding. The Commission's Office of Trial Staff ("OTS") is not a Signatory Party. Hess Corporation ("Hess") is not a Signatory Party, but has indicated that it does not oppose the Settlement.

I. HISTORY OF THE PROCEEDING

1. On September 16, 2008, Dominion Peoples and PH Gas filed a Joint Application seeking certificates of public convenience from the Commission, pursuant to 66 Pa. C.S. §§ 1102, 1103, authorizing PH Gas to acquire all the outstanding stock of PNGC from Dominion. The proposed stock transfer constitutes a change of control according to the Commission's guidelines and policy statement at 52 Pa. Code § 69.901.
2. On October 2, 2008, OTS filed its Notice of Appearance. On October 7, 2008, the Office of Consumer Advocate ("OCA") filed a protest to the Joint Application. On October 14, 2008, the Office of Small Business Advocate ("OSBA") filed a protest against the Joint Application. On October 14, 2008, Hess filed a Petition to Intervene. No other protests or petitions to intervene were filed.

² Reference to "Dominion Peoples" is used herein where the Signatory Parties (defined below) intend to refer specifically to PNGC under the ownership of Dominion. The term "Joint Applicants," as used herein, collectively refers to Dominion Peoples and PH Gas.

³ The parties signing this Joint Petition are collectively referred to herein as the "Signatory Parties."

⁴ There is no separate Settlement Agreement. The Signatory Parties' signatures affixed to this Joint Petition represent agreement to the terms and conditions contained herein.

3. On October 16, 2008, the Joint Applicants filed the following direct testimony: PH Gas St. No. 1, Direct Testimony of Christopher P. Kinney; PH Gas St. No. 2, Direct Testimony of Michael J. Cyrus; PH Gas St. No. 3, Direct Testimony of James L. Warren; and Dominion Peoples St. No. 1, Direct Testimony of Bruce C. Klink.
4. The Joint Application was assigned to the Office of Administrative Law Judge for hearing and decision. A prehearing conference was held on November 13, 2008, before Administrative Law Judge ("ALJ") Robert P. Meehan. A procedural and discovery schedule was set at the prehearing conference.
5. The parties engaged in extensive discovery and amicably resolved all discovery disputes without having to involve the presiding officer.
6. On December 18, 2008, the following direct testimony of the Public Advocates was served: OTS St. No. 1, Direct Testimony of Amanda Gordon; OSBA St. No. 1, Direct Testimony of Brian Kalcic; OCA St. No. 1, Direct Testimony of Ralph C. Smith; OCA St. No. 2, Direct Testimony of Aaron L. Rothschild; OCA St. No. 3, Direct Testimony of Barbara R. Alexander; and, OCA St. No. 4, Direct Testimony of Ralph E. Miller. Hess did not serve any direct testimony.
7. On January 22, 2009, the Joint Applicants served the following rebuttal testimony: PH Gas St. No. 1R, Rebuttal Testimony of Christopher P. Kinney; PH Gas St. No. 2R, Rebuttal Testimony of Michael J. Cyrus; PH Gas St. No. 3R, Rebuttal Testimony of James L. Warren; Dominion Peoples St. No. 1R, Rebuttal Testimony of Bruce C. Klink; Dominion Peoples St. No. 2R, Rebuttal Testimony of William E. McKeown; and,

Dominion Peoples St. No. 3R, Rebuttal Testimony of Sadie Kroeck. The OSBA also filed OSBA St. No. 2, Rebuttal Testimony of Brian Kalcic.

8. On February 6, 2009, on an informal telephonic conference with ALJ Meehan, the Parties jointly requested a suspension of the previously established litigation schedule, which was granted at a prehearing conference on April 2, 2009. The litigation schedule was reestablished at prehearing conferences held on May 3, 2009 and May 29, 2009.
9. On May 20, 2009, the Joint Applicants submitted the Supplemental Testimony of Christopher P. Kinney, PH Gas St. No. 1 (Supp.).
10. On July 27, 2009, the Public Advocates submitted the following surrebuttal testimony: OTS St. No. 1-SR, Surrebuttal Testimony of Amanda Gordon; OSBA St. No. 3, Surrebuttal Testimony of Brian Kalcic; OCA St. No. 1S, Surrebuttal Testimony of Ralph C. Smith; OCA St. No. 2S, Surrebuttal Testimony of Aaron L. Rothschild; OCA St. No. 3S, Surrebuttal Testimony of Barbara R. Alexander; OCA St. No. 4S, Surrebuttal Testimony of Ralph E. Miller. Hess did not serve any surrebuttal testimony.
11. On August 7 and 10, 2009, the Joint Applicants served the following rejoinder testimony: PH Gas St. No. 1RJ, Rejoinder Testimony of Christopher P. Kinney; PH Gas St. No. 2RJ-1, Rejoinder Testimony of Michael J. Cyrus; PH Gas St. No. 2RJ-2, Rejoinder Testimony of Michael J. Cyrus; PH Gas St. No. 3RJ, Rejoinder Testimony of James I. Warren; Dominion Peoples St. No. 1RJ, Rejoinder Testimony of Bruce C. Klink; and, Dominion Peoples St. No. 1RJ-2, Additional Rejoinder Testimony of Bruce C. Klink.

12. Evidentiary hearings were held before ALJ Meehan on August 12, 2009. At the hearings, the Parties moved into evidence their respective testimonies and exhibits, and witnesses were cross-examined.⁵ The Joint Applicants and Hess entered into a Joint Stipulation which was entered into the evidentiary record.
13. Pursuant to the procedural schedule set by ALJ Meehan, Main Briefs are due September 11, 2009. Reply Briefs are due September 18, 2009.

II. TERMS AND CONDITIONS OF SETTLEMENT

The Signatory Parties agree to resolve all issues in the instant proceeding amongst the Signatory Parties on the following terms and conditions:

A. Financial Conditions

14. The existence of an acquisition premium for ratemaking purposes will be determined under the Uniform System of Accounts (Account 114).
15. Any acquisition premium recorded on PNGC's books will be permanently excluded from rate base in establishing future rates subject to the Commission's jurisdiction.
16. PNGC will not claim, in any future rate proceedings, Transaction and Transition costs to complete the transaction designated as unrecoverable as such items are identified and set forth in **Appendix A** and any related tax effect for such items shall also be excluded in setting rates.

⁵ Upon motion of the OTS, Dominion Peoples St. No. 1RJ-2, Additional Rejoinder Testimony of Bruce C. Klink, was excluded from the evidentiary record.

17. PNGC's debt costs will be established in future rate proceedings. It will be PNGC's burden to demonstrate that its debt costs are reasonable. All parties reserve their right to review and challenge any debt cost claim.
18. PNGC will not defer any Transaction or Transition costs identified in Paragraph 16 above; such costs shall be borne exclusively by Peoples' shareholders.
19. On the closing date ("Closing Date"), Dominion will deposit an amount equal to \$35 million in cash into an irrevocable trust ("Trust") exclusively for the benefit of the ratepayers of PNGC. The deposited amount, plus interest earned thereon, net of taxes and Trust expenses, will be flowed to ratepayers as a distribution rate credit.

The Trust will be established at a bank or trust institution selected by PH Gas and acceptable to the OCA, OTS and OSBA. The trustee ("Trustee") of the trust will manage the affairs of the Trust, including deposits into the Trust, withdrawals from the trust, payment of Trust expenses, investment decisions and other Trust activities and the reporting thereof to the relevant parties pursuant to the terms of a trust agreement ("Trust Agreement"). The first \$25,000 of costs and expenses of establishing and maintaining the Trust for its expected four year term will be an expense of the Trust and payable out of the Trust estate. The remainder of costs and expenses will be paid by PNGC and will not be recoverable from ratepayers. All interest earnings on investments in the Trust will inure to the benefit of the Trust estate; provided however that, to the extent that any party hereto is deemed to have earned taxable income on investment earnings of the Trust (but not its principal), then the Trustee shall pay to such party an amount equal to the tax due in respect of such earnings at such times as such taxes are payable.

The Trust Agreement shall set forth the parameters pursuant to which Trust funds shall be invested by the Trustee, provided that the overarching objective of the Trustee will be the preservation of principal. The Trust Agreement will also set forth the terms upon which the Trustee will release to PNGC amounts sufficient to permit PNGC to apply a ratepayer credit to customers of PNGC equal to the \$35 million initial investment plus interest earned thereon net of (i) any expenses of the Trust and (ii) payments related to taxes described in the previous paragraph. To the extent funds are available in the Trust to do so, PNGC will apply a monthly ratepayer base rate credit for a period of approximately three years, until the funds in the trust have been exhausted, upon which the base rate credit will terminate. The credit shall be calculated on the assumption that funds will be available in the Trust to apply the credit for three years, but the credit will terminate when the funds have actually been exhausted. At the end of each month, the Trust will pay to PNGC amounts equal to the credits applied to customer bills during that month.

The credit will be allocated among the rate classes proportionate to any base rate revenue award in PNGC's next base rate proceeding. The base rate credit shall begin with the compliance filing following the final Commission Order in the next PNGC base rate proceeding. The base rate credit will apply to all classes of PNGC customers; however, the credit will not apply to any competitive customer receiving a discounted rate.

20. The existing base rates of Dominion Peoples, will be capped until January 1, 2011, unless there are substantial changes in regulation or federal tax rates or policy. This paragraph shall not prohibit changes in rates pursuant to the State Tax Adjustment Surcharge.

21. PNGC will not propose a charge for recovery of costs associated with post test year plant additions (DSIC mechanism) to become effective prior to January 1, 2011.
22. Costs for any non-regulated capital projects or costs that are not for purposes of providing service to PNGC's retail utility customers will be excluded from base rates and related financing costs will be excluded to establish the cost of capital for ratemaking purposes as will revenues from such services provided to entities other than retail utility customers. Revenues derived from the use of regulated assets shall be reflected in rates unless otherwise excluded by the Commission. This Settlement contains no determination of whether any Rager Mountain storage expansion is to be treated as a regulated or non-regulated asset.
23. PNGC or PH Gas shall issue and maintain separately issued debt held by investors not affiliated with SteelRiver or its affiliates, unless the Commission determines that ratepayers will experience a net benefit from any other Company proposal.
24. PNGC will not request a capital structure for ratemaking purposes which is outside the range of capital structures employed by comparable gas distribution companies. All parties reserve their right to review and challenge any proposed capital structure.
25. For a three-year period following closing PNGC will provide thirty (30) day's prior notice to the Commission, the OCA, OTS, and OSBA if it intends to make a distribution to PH Gas which distribution will cause its actual debt ratio, excluding working capital facilities, to exceed 55% of total capitalization.

26. LDC Holdings' consolidated long term debt ratio as a percent of total capitalization shall not exceed 60% for any period longer than one year absent approval from the Commission. Any request for approval will be considered on an expedited basis, if so requested.
27. PNGC will be ring fenced from other companies owned by SteelRiver as described in the Joint Application and in the Response to Interrogatory OTS-8 (attached as **Appendix B**).
28. PNGC's dividends to PH Gas shall be limited to no more than 100% of retained earnings.
29. PNGC shall not do the following except as approved by the Commission upon a showing of net benefit to retail customers:
 - a. guarantee the debt or credit instruments of PH Gas, LDC Holdings, LDC Funding, SteelRiver or any affiliate not regulated by the Commission;
 - b. mortgage utility assets on behalf of PH Gas, LDC Holdings, LDC Funding, SteelRiver or such affiliates other than in conjunction with financing provided by PH Gas to PNGC; or
 - c. loan money or otherwise extend credit to PH Gas, LDC Holdings, LDC Funding, SteelRiver or such affiliates for a term of one year or more.

B. Books and Records

30. PNGC shall maintain reasonable accounting controls and pricing protocols to govern transactions with affiliates, and provide the Commission, OTS, OCA and OSBA reasonable access to the books, records and personnel of PNGC's affiliates where

necessary for the Commission to adequately review PNGC's purchases of goods or services from those affiliates.

31. Upon written request, PH Gas and its subsidiaries will provide the Commission, the OTS, the OCA and the OSBA reasonable access to the books and records, officers and staff of PH Gas and its subsidiaries. However, nothing set forth herein shall constitute or be interpreted as a waiver by PH Gas or its subsidiaries of its right to raise traditional discovery objections to any such requests, including, but not limited to, objections on the basis of relevance and privilege. In addition, before responding to any such requests, PH Gas and its subsidiaries shall be permitted to require the imposition of protections they deem necessary to prohibit disclosure of proprietary or confidential information.
32. PNGC, and its parents (including SteelRiver), will provide, upon request, to the Commission, OTS, OCA and OSBA, in connection with rate proceedings and other proceedings before the Commission presentations given by SteelRiver or PNGC to common stock, bond, or bond rating analysts, that directly, or indirectly pertain to PNGC.
33. PNGC will seek Commission approval of all new or amended agreements with affiliates consistent with Chapter 21 of the Public Utility Code.
34. PH Gas and its subsidiaries shall provide the OTS, OCA and OSBA with a copy of any reports filed with the US Securities and Exchange Commission upon request.
35. For the five (5) calendar years following closing, PNGC will provide an annual report to the Commission as to the status of all material commitments made in any settlement.

C. Corporate Cost Allocations

36. PNGC's corporate cost allocations will include a rent charge for the percentage of space occupied by employees who provide services to an affiliate, and a supplies charge for supplies the employee may use in providing services to affiliates.
37. PNGC's corporate cost allocations will provide that all charges by PH Services to PNGC will be at cost, provided that nothing herein shall affect PNGC's burden of proof under 66 Pa. C.S. § 2106.

D. Management

38. SteelRiver will not permit a change in ownership in PNGC, including as consequence of termination of SteelRiver, without prior Commission approval if such change would result in a change in control under the then-applicable Commission standards.
39. The CEO of PNGC will be a member of the governing board of PH Gas.
40. SteelRiver will continue to maintain PNGC's corporate headquarters in PNGC's service area and in or near Pittsburgh, Pennsylvania. PNGC agrees not to move PNGC headquarters outside PNGC service territory for at least a ten year period and will only do so after that time upon Application to and approval by the Commission.
41. PNGC commits to maintain field offices in its service territory and staffing levels that are sufficient to provide safe and reliable service. PNGC will provide annual reports to the Commission, OTS, OSBA, and OCA regarding field offices and staffing levels in its service territory for a period of five years.

E. Reliability and Customer Service

42. PNGC commits to make customer service metrics a priority. To that end, PNGC commits to the specific quality of service metrics attached hereto as **Appendix C**, in accordance with paragraph 45 below.
43. For a maximum period of up to 18 months after the Closing, and pursuant to the terms (including, without limitation, the payment terms) of the Transition Services Agreement (“TSA”), PNGC will use Dominion for, and Dominion will provide, customer service arrangements. Prior to the end of such 18 month period, PH Gas shall (i) employ adequate staff and supervisory personnel to allow PNGC or its affiliates to succeed Dominion in performing the full customer service functions; or (ii) cause PNGC to execute (and obtain Commission approval in accordance with, and subject to, ¶ 44 below) a contract with one or more third parties to succeed Dominion in performing customer service functions that will not be provided by employees of PNGC or its affiliates. PNGC will conduct an RFP for customer service arrangements that will not be performed by PNGC, after consultation with OTS, OCA, OSBA and the Commission’s Bureau of Consumer Services as to the specifications of the RFP. The RFP will be issued to prospective bidders within six months of the closing
44. PNGC will submit a filing containing the proposed contract with the selected vendor (the “Selected Customer Service Vendor”) for customer service arrangements to the Commission and the parties for consideration, review and approval by the Commission at a separately docketed proceeding. The parties shall be given the opportunity to provide written comments on the contract. The Commission shall approve or reject the contract

within 90 days of filing. PNGC will arrange a back up supplier for provision of customer service functions that cannot be provided by PNGC in the event that contract with the selected vendor is not approved in sufficient time to become operational at the end of the 18 month TSA period.

45. PNGC will provide a report to OCA, OTS, and OSBA each calendar year following commencement of service by the Selected Customer Service Vendor or assumption of such functions by the staff of PNGC or its affiliates regarding its achievement of the service quality metrics in **Appendix C**. Such reports shall continue for three calendar years after selection of the Selected Customer Service Vendor or assumption of such functions by the staff of PNGC or its affiliates. The report will outline the actual metrics achieved and additional actions expected to be taken in the following year to further improve customer service. If the Company has not achieved an identified metric (in **Appendix C**), the report will also include the reasons for the failure and the Company's detailed plan to reach the service quality metric and will follow the reporting procedures set forth in Paragraph 46. PNGC will then convene a collaborative with OCA, OTS and the OSBA to discuss such report. The Commission may, upon motion of any Party or upon its own motion, open a formal proceeding. If, following such a collaborative, OTS, OCA or OSBA request a proceeding before the Commission, PNGC will not oppose the initiation of such a proceeding.
46. PNGC will commit to assess and identify areas of necessary improvement and submit that analysis to the Commission, OCA, OTS and OSBA within 180 days of closing for their review and comment. This review will additionally outline cost effective systems for improvement of customer service and expected service improvements.

47. Nothing in this Settlement is intended to restrict the Company's right to request recovery of new systems to improve service, including as a consequence of an existing system's age, obsolescence or other requirements, as appropriate, in future rates. Any such request will be subject to review for reasonableness and prudence in accordance with rate making principles.
48. No party waives any right to request that the Commission order penalties in any proceeding convened to investigate the Company's noncompliance with the service metrics in **Appendix C**.
49. Nothing contained herein is intended to limit the authority of the Commission, the Bureau of Consumer Services, the Bureau of Safety and Compliance or other Bureaus of the Commission from performing their duties and making recommendations, including recommendations regarding fines, for failure of PNGC to perform in any of the areas contained in **Appendix C**.

F. Universal Service

50. PNGC will continue to fund its Customer Assistance Program ("CAP") consistent with its needs analysis approved in conjunction with the Dominion Peoples currently approved Universal Services Plan.
51. PNGC will manage its CAP program similar to that of Columbia Gas in that it will partner with an agency that: (a) can substantially increase the number of intake sites; (b) is an administrator of utility CAP programs for the EDCs or NGDCs in their territory; (c)

recruits and partners with multi-service agencies; and, (d) uses a case management system to track and monitor referrals and enrollments into utility programs.

52. PNGC will be permitted to recover CAP costs under Dominion Peoples' existing recovery mechanism for CAP costs. PNGC may propose changes to the recovery mechanism, which any party to the Settlement may oppose, for review by the Commission. The provisions of Paragraph No. 20 shall not limit implementation of any change to PNGC's recovery mechanism. Nothing in this Settlement shall be construed to alter the settlement reached in *Pennsylvania Public Utility Commission v. The Peoples Natural Gas Company d/b/a Dominion Peoples*, Docket No. R-00051093.
53. PNGC will match customer contributions to its Hardship Fund with up to \$300,000 of shareholder funds annually for three years commencing January 1, 2010. PNGC will provide up to \$50,000 annually in administrative funds for a three-year period commencing January 1, 2010. PNGC will review possible ways to increase outreach to customers to attempt to increase customer contributions and will provide a report to the Commission and OCA.
54. PNGC will commit to an increase in LIURP funds to \$768,000 per year with the amount above the current \$610,000 per year to be borne by the Company until the end of the period in Paragraph 20. Any funds not used in one year will roll-over on into the next calendar year. Funding on this basis will continue until the effective date of rates set in the next base rate proceeding.

G. Community Commitment

55. For a period of not less than five years, PNGC will provide corporate contributions and community support in southwestern Pennsylvania in a total amount that is at least equivalent to the amount provided by PNGC in 2007 (\$18,250).
56. Services that are currently performed for PNGC outside of Pennsylvania, such as call center support, customer billing and payment and customer relations, will be returned to Pennsylvania.
57. PNGC will continue to comply with the Commission's diversity policy, 52 Pa. Code §§ 69.801-69.809.

H. Gas Purchasing

58. PNGC will retain or designate an officer (the "Responsible Officer") with experience and qualifications in gas supply matters. The Responsible Officer will be responsible for the review and independent evaluation of all substantive changes in contracts for gas supply transportation, storage or procurement obligations ("Gas Supply Services"). Any such contract will remain a contract between PNGC and the provider of the gas supply service.
59. PNGC will retain adequate gas supply procurement oversight personnel on staff. PNGC will include these individuals among its expert witnesses in its 1307(f) proceedings.
60. For a maximum period of up to 18 months after the Closing and pursuant to the terms (including, without limitation, the payment terms) of the TSA, PNGC will use Dominion for, and Dominion will provide, gas purchasing and supply arrangements after closing.

In such 18 month period, PH Gas either (i) shall employ adequate staff and supervisory personnel to allow PNGC or its affiliates to succeed Dominion in performing the full gas procurement functions; or (ii) cause PNGC to execute (and obtain Commission approval in accordance with ¶ 61) a contract with a third party to succeed Dominion in performing procurement functions that will not be provided by employees of PNGC or its affiliates. PNGC will conduct an RFP for gas procurement that will not be performed by PNGC, after consultation with OTS, OCA, and the OSBA as to the specifications of the RFP. The RFP will be issued to prospective bidders within six months of the closing.

61. PNGC will submit a filing containing the proposed contract with the selected vendor (the "Selected Gas Procurement Vendor") for gas procurement functions to the Commission and the parties for consideration, review and approval by the Commission as a separately docketed proceeding. OTS, OCA and OSBA shall, commencing on the date of the filing, have full discovery rights with regard to the contract and PH Gas/PNGC will provide the parties with informal discovery as requested. The parties shall be given the opportunity to provide written comments on the contracts. The Commission shall approve or reject the contract within 90 days of filing. PNGC will arrange a back up supplier for the provision of gas procurement functions that cannot be provided by PNGC in the event that the contract with the selected vendor is not approved in sufficient time to become operational at the end of the 18 month TSA period.
62. PNGC must comply with the Commission approved 1307(f) plan current at the time of closing.

63. If PNGC outsources gas procurement functions, any contracts with its gas supply and procurement contractors for such service will include protective provisions. Three such provisions which must be included in these contracts, are as follows: (i) PNGC has the right to audit all the books and records associated with any buying, selling or other activities that may affect PNGC; (ii) Parties to any PNGC 1307(f) proceeding have full discovery rights as to any gas supply and procurement vendor, including, subject to confidentiality protections, the right to discovery about the vendor's transactions with its affiliates, and such vendor must comply with the procedural schedule established in each 1307(f) proceeding (regarding discovery); and, (iii) the Gas Supply and Procurement Vendor must present a witness to testify in PNGC 1307(f) proceedings.
64. Should PNGC contract with an external Procurement Services Provider ("PSP"), PNGC will include provisions in the contract with the PSP to provide all information to the Commission and Parties that would be required to be provided by PNGC if it were purchasing gas supplies subject to the Commission's discovery and confidentiality rules.

I. Retail Supply Competition

65. PNGC will convene a collaborative conference with interested parties, including the OCA, OTS, OSBA and interested natural gas suppliers, within 12 months of closing in order to develop a strategy to promote retail natural gas supply competition.

J. Lost and Unaccounted For Gas

66. Pursuant to the settlement in Dominion Peoples 2008 1307(f) proceeding, Dominion Peoples committed to the following:

Dominion Peoples will immediately initiate steps to begin monitoring Unaccounted for gas ("UFG") levels on its gathering system. Dominion Peoples will begin to quantify UFG levels as soon as possible once an initial detailed operational review of its gathering system is conducted. This review is needed in order to separately identify and segment, among other things:

a. all gas measurement points (and associated volumes) where gas is delivered from the gathering system into the transmission system;

b. all end-use customers (and associated volumes) that are located on the gathering system; and

c. all gas used in the operation of compression and dehydration units located on the gathering system.

Dominion Peoples will provide available gathering system UFG data and report related findings in its 2009 1307(f) proceeding.

Following the closing, PNGC will review Dominion Peoples' initial detailed operational review of the gathering system and the Commission's findings in Dominion Peoples' 2009 1307(f) proceeding and PNGC's 2010 1307(f) proceeding. It will conduct a review of Dominion Peoples' prior efforts to reduce UFG and examine alternative additional measures to reduce UFG – including costs to implement such measures and potential cost savings that might be derived from implementing additional measures to reduce UFG.

PNGC will present a report to OSBA, OTS and OCA with regard to the results of such investigation no later than the filing of PNGC's 2011 1307(f) proceeding. Nothing in this Settlement is intended to affect any obligations of PNGC to control UFG that may be ordered by the Commission in the proceeding at *Pennsylvania Public Utility Commission v. The Peoples Natural Gas Company d/b/a Dominion Peoples*, Docket No. R-2009-2088069.

67. The Parties stipulate that for ratemaking, deferred taxes will be per PNGC's books as calculated under federal normalization rules (and reflecting the appropriate deferred tax elements for ratemaking purposes such as taxes associated with CIAC) and no party will propose or support an adjustment to this treatment related to this acquisition.
68. This Settlement is conditioned upon the Commission granting all necessary approvals for the acquisition and all proposed changes in corporate structure including the conversion of PNGC to an LLC by merger into a new corporation under Pennsylvania law. The Parties agree that they will not oppose Security Certificate filings and related affiliate interest filings by PNGC necessary to refinance Dominion Peoples notes to Dominion as described in the Application.

III. REASONS THAT SETTLEMENT IS IN THE PUBLIC INTEREST

69. Commission policy promotes settlements. *See* 52 Pa. Code § 5.231. Settlements lessen the time and expense the parties must expend litigating a case and, at the same time, conserve precious administrative resources. The Commission has indicated that

settlement results are often preferable to those achieved at the conclusion of a fully litigated proceeding. *See id.* § 69.401. In order to accept a settlement, the Commission must first determine that the proposed terms and conditions are in the public interest. *Pa. Pub. Util. Comm'n v. York Water Co.*, Docket No. R-00049165 (Order entered Oct. 4, 2004); *Pa. Pub. Util. Comm'n v. C.S. Water and Sewer Assocs.*, 74 Pa. P.U.C. 767 (1991). As will be detailed in the Signatory Parties' Statements in Support of Settlement, the instant Settlement is in the public interest because, with the conditions imposed herein, the proposed transaction will provide substantial affirmative public benefits.

70. Approval of the Settlement will lessen the time and expenses that the Signatory Parties, and the Commission, must expend on the proceedings.
71. The Settlement resolves all issues in the instant proceeding between the Signatory Parties.
72. There were no customer protests against the Joint Application.
73. The Signatory Parties will further supplement the reasons that the Settlement is in the public interest in their Statements in Support of Settlement, which will be filed no later than September 11, 2009.

IV. PROCEDURAL CONDITIONS OF SETTLEMENT

74. The Settlement is conditioned upon the Commission's approval of the terms and conditions contained in this Joint Petition without modification. If the Commission

modifies the Settlement, any Signatory Party to this Joint Petition may elect to withdraw from the Settlement and may proceed with litigation and, in such event, the Settlement shall be void and of no effect. Such election to withdraw must be made in writing, filed with the Secretary of the Commission and served upon all Parties within five business days after the entry of an Order modifying the Settlement.

75. This Settlement is proposed by the Signatory Parties to this Joint Petition to settle and forever resolve all issues in the instant proceeding. If the Commission does not approve the Settlement and the proceedings continue, the Signatory Parties reserve their respective procedural rights. The Settlement is made without any admission against, or prejudice to, any position which any Signatory Party may adopt in the event of any subsequent litigation of these proceedings, or in any other proceeding.
76. The Signatory Parties to this Joint Petition acknowledge that the Settlement reflects a compromise of competing positions and does not necessarily reflect any party's position with respect to any issues raised in this proceeding. The Signatory Parties agree that the Settlement shall not constitute or be cited as precedent in any other proceeding, except to the extent required to implement the Settlement.
77. The Signatory Parties to this Joint Petition agree to support this Settlement in any Statements in Support, briefs and other filings, including exceptions and replies to exceptions, that they may elect to file in this proceeding.
78. The Settlement may only be amended by a written document duly agreed to and executed by the Signatory Parties to this Joint Petition.

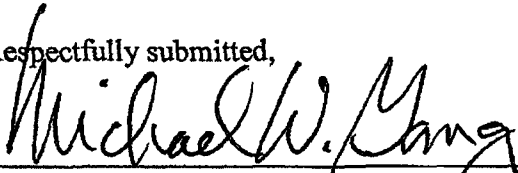
V. CONCLUSION

WHEREFORE, Peoples Hope Gas Companies LLC (an indirect subsidiary of SteelRiver Infrastructure Fund North America LP), The Peoples Natural Gas Company d/b/a Dominion Peoples, Dominion Resources, Inc., the Office of Consumer Advocate, and the Office of Small Business Advocate, by their respective counsel, respectfully request as follows:

(a) That the Honorable Administrative Law Judge Robert P. Meehan recommend approval of, and the Commission approve, this Joint Petition for Approval of Settlement including all terms and conditions thereof without modification; and,

(b) That the Commission issue certificates of public convenience evidencing approval under Section 1102(a)(3) of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 1102(a)(3), of the acquisition by transfer of all of the issued and outstanding shares of capital stock of The Peoples Natural Gas Company, d/b/a Dominion Peoples, currently owned by Dominion Resources, Inc., to Peoples Hope Gas Companies LLC, an indirect subsidiary of SteelRiver Infrastructure Fund North America LP, and approval of the resulting change in control of The Peoples Natural Gas Company, d/b/a Dominion Peoples.

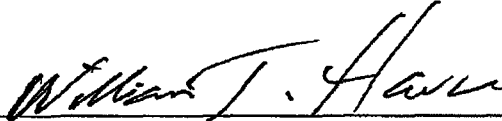
Respectfully submitted,



Michael W. Gang, Attorney I.D. No. 25670
David P. Zambito, Attorney I.D. No. 80017
Post & Schell, P.C.
17 North Second Street
12th and 14th Floors
Harrisburg, PA 17101-1601
Telephone: 717-731-1970
Facsimile: 717-731-1985
E-mail: mgang@postschell.com; dzambito@postschell.com
Counsel for
*Peoples Hope Gas Companies LLC, an indirect subsidiary
of SteelRiver Infrastructure Fund North America LP*

Date:

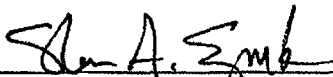
9/4/09



William T. Hawke, Esquire, Attorney I.D. No. 19595
Janet L. Miller, Esquire, Attorney I.D. No. 63491
Tori L. Giesler, Esquire, Attorney I.D. No. 207742
Hawke McKeon & Sniscak LLP
100 N. Tenth Street
P. O. Box 1778
Harrisburg, PA 17105-1778
Telephone: 717-236-1300
Facsimile: 717-236-4841
E-mail: wthawke@hmslegal.com; jlmiller@hmslegal.com;
tlgiesler@hmslegal.com
Counsel for
*The Peoples Natural Gas Company, d/b/a Dominion
Peoples, and Dominion Resources, Inc.*

Date:

9-4-09



Shaun A. Sparks, Esquire
Jennedy S. Johnson, Esquire
Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101-1923
Telephone: 717-783-5048
Facsimile: 717-783-7152
E-mail: SSparks@paoca.org; JJohnson@paoca.org
Counsel for *Office of Consumer Advocate*

Date:

9-4-09



Date: 9/4/09

Lauren M. Lepkoski, Esquire
Sharon Webb, Esquire
Office of Small Business Advocate
Commerce Building, Suite 1102
300 North Second Street
Harrisburg, PA 17101-1303
Telephone: 717-783-2525
Facsimile: 717-783-2831
E-mail: llepkoski@state.pa.us; swebb@state.pa.us
Counsel for *Office of Small Business Advocate*

APPENDIX A

SteelRiver
Allocation of Certain Costs Incurred
(All amounts are estimates in \$000's)
Second revision per discussions with PA OCA 2817 Aug 2009

	Amount	Peoples					Hope
		Financing Costs PH Gas/Peoples	Customer Care	Financing Costs Holdings & other (nonrecoverable)	Transaction Cost (nonrecoverable)	Transition Costs (nonrecoverable)	
Legal Counsel							
SteelRiver	700						143
Lenders	700				557		164
Pennsylvania	350			536			-
West Virginia	250				350		250
	2,000			536	907		557
Due Diligence							
Legal	400			216	102		82
Engineering	50			27	13		10
Environmental	10			5	3		2
Market	100			54	26		20
Insurance	50			27	13		10
Financial	200			108	51		41
Audit	40			22	10		8
Other	50			27	13		10
	900			487	230		184
Debt ⁽¹⁾							
Peoples Commitment Fees	1,792	1,792					-
Peoples Upfront Fee	10,428	10,428					-
Hope Commitment Fees	579						579
Hope Upfront Fee	3,372						3,372
Holdings Commitment Fees	1,375			1,100			275
Holdings Upfront Fee	4,000			3,200			800
	21,546	12,220		4,300			5,026
Customer Care							
Consultants	1,000		757				243
Hardware	2,000		1,514				486
Software	3,000		2,270				730
	6,000		4,541				1,459
SteelRiver							
Setup	250				199		51
Tax	250				199		51
Communications	500				398		102
	1,000				796		204
Transition							
Signage, etc	2,000					1,592	408
Other							
Travel, etc	1,500				1,194		306
Total	34,946	12,220	4,541	5,323	3,127	1,592	8,143

(1) Debt costs here are per the model provided in response to OTS-10. Differences from the amounts shown in OTS-9 are due to rounding in the response to OTS-9.

APPENDIX B

Pennsylvania Public Utility Commission
Commonwealth of Pennsylvania
Docket No. A-2008-2063737
The Peoples Natural Gas Company, Dominion Resources, Inc.
and Peoples Hope Gas Companies LLC
Joint Application

Office of Trial Staff Interrogatories ("OTS")
Set No. 1

Interrogatories and Document Requests Served October 6, 2008

OTS – 8 Identify any additional planned financial safeguards to be adopted post-merger to protect the independent financial integrity of Peoples Natural Gas Company.

RESPONSE: By: Cliff Losh - BBIFNA

As described in the Joint Application, including the corporate diagram provided in Appendix E thereto, post-merger, the structure of the Transaction provides several safeguards to protect the financial integrity of Peoples in addition to those safeguards that exist currently. These additional safeguards include:

- Maintaining Peoples as a separate, single purpose corporate entity;
- Establishing a "sister" entity (PH Services) that will provide essential services to Peoples (and Hope) on an arms-length basis consistent with a Commission-approved affiliated interest agreement;
- Establishing at least one single purpose holding company (Holdings) above PH Gas (the direct parent of Peoples, Hope and PH Services) thereby separating Peoples from any other of BBIFNA's businesses and separating other BBIFNA businesses from that of Peoples;
- Committing to a capital structure for Peoples that limits debt (other than working capital borrowings) at Peoples to no more than 45-55% of total capitalization without notification to the Commission, OCA and OSBA;
- Committing that the outstanding debt of Peoples would be held by investors unaffiliated with Peoples unless notification is given to the Commission, OCA and OSBA;
- A corporate structure whereby PH Gas will provide a guarantee of the Senior Term Loan Facility of each of Peoples and Hope, under which equity distributions by PH Gas to Holdings will be restricted and will be available to service the Senior Term Loan Facility of either of Peoples or Hope to the extent that there is a shortfall in cash flow available to pay the debt service of such utility;

In addition, the Senior Credit Facilities referred to on Page 20 of the Joint Application contain a series of affirmative and negative covenants intended to safeguard the financial integrity of Peoples (and Hope).

APPENDIX C

Performance Indicator	Proposed Annual Performance Standard
1. Call Center: % calls answered w/in 30 seconds	70% in Year 1; 75% in Year 2; 80% in Year 3
2. Call Center: Average busy-out Rate	Below 0.5%
3. Call Center: Average Call Abandonment Rate	7% in Year 1; 6% in Year 2; 5% in Year 3
4. # of Customer disputes not issued a report within 30 days	No more than 3% of the Total Number of disputes filed
5. % of Meters not read as required by 56.12(4) (ii-6 mos.) and (iii-12 mos.)	Not read in 6 months: .25% Not Read in 12 months: .03%
6. Gas Safety Response Time	No degradation from the Companies three-year average response times of 97% in 60 minutes.
7. Percent of bills not rendered once every billing period	.01%

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Joint Application for All of the Authority	:	
and the Necessary Certificates of Public	:	
Convenience to Transfer All of the Issued	:	
and Outstanding Shares of Capital Stock of	:	Docket No. A-2010-2210326
T. W. Phillips Gas and Oil Co., currently	:	
owned by TWP INC., to LDC Holdings II	:	
LLC, an indirect subsidiary of SteelRiver	:	
Infrastructure Fund North America LP, and	:	
to Approve the Resulting Change in	:	
Control of T. W. Phillips Gas and Oil Co.	:	

JOINT PETITION FOR APPROVAL OF SETTLEMENT OF ALL ISSUES

TO THE HONORABLE DAVID A. SALAPA AND CONRAD A. JOHNSON

I. INTRODUCTION

T. W. Phillips Gas and Oil Co. ("T. W. Phillips"), TWP INC. ("TWP"), LDC Holdings II LLC ("Holdings II"),¹ the Office of Trial Staff ("OTS") of the Pennsylvania Public Utility Commission ("Commission"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), and the Pennsylvania Independent Oil and Gas Association ("PIOGA"),² all parties to the above-captioned proceeding (hereinafter, singularly "Signatory Party" and collectively "Signatory Parties"), hereby join in this "Joint Petition for Approval of Settlement of All Issues" ("Settlement") and respectfully request that Administrative Law Judges David A. Salapa and Conrad A. Johnson (the "ALJs") and the Commission approve the above-captioned Joint Application ("Joint Application") consistent with the terms and conditions set

¹ Hereinafter, T. W. Phillips, TWP, and Holdings II will collectively be referred to as the "Applicants."

² In addition, T. W. Phillips Large Users Group ("TWPLUG"), the only other active party in this proceeding, has indicated that it neither supports nor opposes the Settlement.

forth in this Settlement. This Settlement represents a full settlement of all issues between all parties in the instant proceeding. In support of the Settlement, the Signatory Parties state the following:

II. BACKGROUND

1. T. W. Phillips is a "public utility" and a "natural gas distribution company" as those terms are defined in Sections 102 and 2202 of the Public Utility Code, 66 Pa. C.S. §§ 102, 2202. T. W. Phillips provides natural gas services to approximately 63,000 customers throughout its service territory, which includes all or portions of the following Pennsylvania counties: Allegheny, Armstrong, Beaver, Butler, Cambria, Clarion, Clearfield, Indiana, Jefferson, and Westmoreland.

2. Holdings II is a Delaware limited liability company formed to effectuate the transaction proposed by the Joint Application ("Proposed Transaction") and acquire the common stock of T. W. Phillips under the Stock Purchase Agreement, executed on November 1, 2010, between TWP and Holdings II ("SPA") (a copy of which was attached to the Joint Application). Holdings II is a wholly owned subsidiary of LDC Funding LLC ("Funding"). Funding is a Delaware limited liability company and a wholly-owned direct subsidiary of SteelRiver Infrastructure Fund North America LP ("SRIFNA"). SRIFNA is an independent investment fund specializing in infrastructure assets. SRIFNA's investment focus is to invest for the long-term in infrastructure businesses that provide essential services.

3. SRIFNA currently owns and manages infrastructure investments throughout North America, with committed capital in excess of \$1.9 billion.

4. On November 10, 2010, the Applicants filed with the Commission the Joint Application requesting all necessary approvals authorizing the transfer by sale of 100% of the

issued and outstanding common stock of T. W. Phillips, currently owned by TWP, to Holdings

II.

5. On November 16, 2010, a Secretarial Letter was issued directing the Applicants to publish notice of the proposed transaction once in a newspaper having a general circulation in the area involved and file proof of publication with the Commission. The Applicants filed Proof of Publication with the Commission on December 13, 2010.

6. On December 7, 2010, a Petition to Intervene was filed by the Utility Workers Union of America, Local 242 ("Local 242"). On January 18, 2011, Local 242 filed a Petition for Leave to Withdraw its Petition to Intervene, which was granted on February 1, 2011.

7. On December 13, 2010, Protests were filed by OCA and TWPLUG.

8. On December 13, 2010, a Petition to Intervene was filed by PIOGA. On December 23, 2010, a Notice of Appearance was filed on behalf of PIOGA.

9. On December 13, 2010, OSBA filed a Notice of Appearance, Notice of Intervention and Protest, and a Public Statement.

10. On December 14, 2010, a Notice of Appearance was filed on behalf of OTS.

11. On January 11, 2011, the Applicants served the following prepared direct testimonies and accompanying exhibits: Direct Testimony of Christopher P. Kinney, Joint Applicants' Statement No. 1 (Highly Confidential and Public Versions); Direct Testimony of Morgan K O'Brien, Joint Applicants' Statement No. 2; and Direct Testimony of Robert M. Hovanec, Joint Applicants' Statement No. 3.

12. On January 13, 2011, the Commission issued a notice scheduling a prehearing conference in the above-captioned matter on January 31, 2011.

13. The Signatory Parties undertook extensive formal and informal discovery, prior and subsequent to the initial prehearing conference.

14. An initial prehearing conference was held before the ALJs on January 31, 2011. The Signatory Parties filed prehearing memoranda identifying potential issues and witnesses. A litigation schedule was established.

15. Pursuant to the request of the Signatory Parties, the due date for Non-Applicant Direct Testimony was extended until April 1, 2011 by order of ALJ Salapa dated April 1, 2011.

16. OSBA served the following direct testimony and accompanying exhibits on March 31, 2011: Direct Testimony of Brian Kalcic, OSBA Statement No. 1. On April 1, 2011, OTS and OCA served the following direct testimony and accompanying exhibits: Direct Testimony of Amanda Gordon, OTS Statement No. 1; Direct Testimony of Joseph Kubas, OTS Statement No. 2; Direct Testimony of Ralph C. Smith, OCA Statement No. 1 (Highly Confidential and Public Versions); and Direct Testimony of Barbara R. Alexander, OCA Statement No. 2. TWPLUG and PIOGA did not serve any direct testimony or exhibits.

17. Settlement discussions were held which produced a settlement in principle of all issues on April 4, 2011. On April 8, 2011, the Signatory Parties advised the ALJs of the settlement in principle and, at the request of the Signatory Parties, the ALJs suspended the procedural schedule.

18. In conjunction with this Settlement, the Signatory Parties have entered into a Stipulation for Admission of Evidence for the admission by stipulation of prepared testimony and exhibits into the record. The Signatory Parties reserve the right to object to testimony and exhibits, present further testimony and exhibits, and to cross-examine witnesses at evidentiary hearings if further litigation of this proceeding is required.

19. The Settlement is set forth in the following Section III.

III. SETTLEMENT

20. The following terms of this Settlement reflect a carefully balanced compromise of the interests of all of the Signatory Parties in this proceeding. The Signatory Parties unanimously agree that the Settlement, which resolves all issues, is in the public interest. The Signatory Parties respectfully request that the Joint Application, as modified by the Settlement, be approved in its entirety subject to the terms and conditions of this Settlement specified below.

A. APPROVAL OF TRANSFER AND ISSUANCE OF CERTIFICATES OF PUBLIC CONVENIENCE

21. The Commission shall issue certificates of public convenience authorizing the transfer by sale of all of the issued and outstanding stock of T. W. Phillips to Holdings II and authorizing the conversion of T. W. Phillips to an LLC by merger into a new corporation under Pennsylvania law, and grant all other approvals as may be appropriate, customary or necessary to carry out the Proposed Transaction set forth in the Joint Application.

B. FINANCIAL CONDITIONS

22. The existence of an acquisition premium for ratemaking purposes will be determined under the Uniform System of Accounts (Account 114).

23. Any acquisition premium recorded on T. W. Phillips' books will be permanently excluded from rate base in establishing future rates subject to the Commission's jurisdiction.

24. T. W. Phillips will not claim, in any future rate proceedings, Transaction and Transition costs to complete the transaction and any related tax effect for such items shall also be

excluded in setting rates. The transaction and transition cost categories designated as unrecoverable are set forth in "Appendix A."

25. T. W. Phillips' debt costs will be established in future rate proceedings. It will be T. W. Phillips' burden to demonstrate that its debt costs are reasonable. All Signatory Parties reserve their right to review and challenge any debt cost claim.

26. T. W. Phillips will not defer any Transaction or Transition costs identified pursuant to Paragraph 24 above and such costs shall be borne exclusively by T. W. Phillips' shareholders.

27. T. W. Phillips will provide a rate credit in a future rate case under the following terms and conditions:

- (a) If the effective date of the first general base rate case increase following the closing is within five years of the Closing Date, T. W. Phillips will provide base rate credits to customers in the total amount of \$10 million.
- (b) If the effective date of the first general base rate case following the closing is more than five years and less than 10 years after the Closing Date, T. W. Phillips will provide base rate credits to customers in the total amount of \$5 million.
- (c) Any base rate credit provided for in subparagraphs 27(a) or 27(b) shall be used to reduce the rates determined in the general rate proceeding and will be allocated to the classes in proportion to the revenues approved in the rate proceeding. Base rate credits shall not be applied to reduce the bills of customers that receive contract rates.

- (d) Any base rate credit will be designed to provide the amounts allocated to each class over not less than a three-year period but not more than a five-year period and will terminate upon exhaustion of the amounts allocated to each class.

28. T. W. Phillips will not increase its existing base distribution rates prior to January 1, 2014, unless there are substantial changes in regulation or federal tax rates or policy. This paragraph shall not prohibit changes in rates pursuant to the State Tax Adjustment Surcharge ("STAS"), Merchant Function Charge or the Universal Service Program charge. If authorized by statute, T. W. Phillips may request a distribution system improvement charge ("DSIC") to become effective after January 1, 2013. All Signatory Parties reserve their rights to address all issues related to this request.

29. Costs for any non-regulated capital projects or costs that are not for purposes of providing service to T. W. Phillips' distribution customers will be excluded from base rates and related financing costs will be excluded to establish the cost of capital for ratemaking purposes as will revenues from such services provided to entities other than distribution customers. Revenues derived from the use of regulated assets shall be reflected in rates unless otherwise excluded by the Commission.

30. T. W. Phillips will not request a capital structure for ratemaking purposes which is outside the range of capital structures employed by comparable gas distribution companies. All Signatory Parties reserve their right to review and challenge any proposed capital structure.

31. T. W. Phillips and Holdings II will adhere to the ring fencing measures provided in "Appendix B."

C. BOOKS AND RECORDS

32. T. W. Phillips shall maintain reasonable accounting controls and pricing protocols to govern transactions with affiliates, and provide the Commission, OTS, OCA and OSBA reasonable access to the books, records and personnel of T. W. Phillips' affiliates where necessary for the Commission to review adequately T. W. Phillips' purchases of goods or services from those affiliates.

33. Upon written request, Holdings II and its subsidiaries will provide the Commission, OTS, OCA and OSBA reasonable access to the books and records, officers and staff of Holdings II and its subsidiaries. However, nothing set forth herein shall constitute or be interpreted as a waiver by Holdings II or its subsidiaries of its right to raise traditional discovery objections to any such requests, including, but not limited to, objections on the basis of relevance and privilege. In addition, before responding to any such requests, Holdings II and its subsidiaries shall be permitted to require the imposition of protections they deem necessary to prohibit disclosure of proprietary or confidential information.

34. Holdings II, and its parents (including SRIFNA), will provide, upon request, to the Commission, OTS, OCA and OSBA, in connection with rate proceedings and other proceedings before the Commission presentations given by Holdings II, Funding, SRIFNA or T. W. Phillips to common stock, bond, or bond rating analysts, that pertain to T. W. Phillips.

35. T. W. Phillips will seek Commission approval of all new or amended agreements with affiliates consistent with Chapter 21 of the Public Utility Code.

36. Holdings II and its subsidiaries shall provide OTS, OCA and OSBA with a copy of any reports filed with the U.S. Securities and Exchange Commission upon request.

37. For the five calendar years following closing, T. W. Phillips will provide an annual report to the Commission as to the status of all material commitments made in this Settlement.

D. CORPORATE COST ALLOCATIONS

38. T. W. Phillips' corporate cost allocations will include a rent charge for the percentage of space occupied by employees who provide services to an affiliate, and a supplies charge for supplies the employee may use in providing services to affiliates.

39. T. W. Phillips' corporate cost allocations will provide that all charges by affiliates to T. W. Phillips will be at cost, provided that nothing herein shall affect T. W. Phillips' burden of proof under 66 Pa. C.S. § 2106.

E. MANAGEMENT

40. SRIFNA will not permit a change in ownership or control in T. W. Phillips, including as a consequence of termination of SRIFNA, without prior Commission approval if such change would result in a change in control under the then-applicable Commission standards.

41. The individual employed as Chief Executive Officer and President of T. W. Phillips will not be the same individual employed as Chief Executive Officer and President of Peoples Natural Gas Company LLC ("Peoples"). The Senior Officer of T. W. Phillips will be Robert Hovanec as President and Chief Operating Officer subject to customary oversight by the Board of Holdings II. All Signatory Parties reserve the right to address this issue if T. W. Phillips and Peoples seek Commission approval for future consolidation or merger.

42. SRIFNA will continue to maintain T. W. Phillips' corporate headquarters in T. W. Phillips' service area and in or near Butler, Pennsylvania. T. W. Phillips agrees not to move

T. W. Phillips' headquarters outside T. W. Phillips' service territory for at least a ten-year period and will only do so after that time by application to and approval by the Commission.

43. T. W. Phillips commits to maintain field offices in its service territory and staffing levels that are sufficient to provide safe, adequate and reliable service as required by Section 1501 of the Public Utility Code, 66 Pa. C.S. § 1501. As part of its annual reports pursuant to Paragraph 37, T. W. Phillips will report to the Commission, OTS, OSBA, and OCA regarding field offices and staffing levels in its service territory.

F. RELIABILITY AND CUSTOMER SERVICE

44. T. W. Phillips commits to make customer service metrics a priority. To that end, T. W. Phillips commits to the specific quality of service metrics attached hereto as "**Appendix C.**" T. W. Phillips commits to dedicate resources sufficient to achieve each metric identified in "**Appendix C.**" If T. W. Phillips has not achieved an identified metric in "**Appendix C,**" T. W. Phillips' annual settlement report required by Paragraph 37 will also include the reasons for the failure and T. W. Phillips' detailed plan to reach the service quality metric.

45. T. W. Phillips will commit to assess and identify areas of necessary improvement, and make improvements intended to enable T. W. Phillips to achieve and maintain metrics in "**Appendix C.**" Within 180 days of closing, T. W. Phillips will submit that analysis to the Commission, OCA, OTS and OSBA for their review and comment. This review will additionally outline cost-effective systems for improvement of customer service and expected service improvements.

46. Nothing in this Settlement is intended to restrict T. W. Phillips' right to request recovery of new systems to improve service, including as a consequence of an existing system's

age, obsolescence or other requirements, as appropriate, in future rates. Any such request will be subject to review for reasonableness and prudence in accordance with ratemaking principles.

47. No Signatory Party waives any right to request that the Commission order penalties in any proceeding convened to investigate T. W. Phillips' noncompliance with the service metrics in "Appendix C."

48. Nothing contained herein is intended to limit the authority of the Commission, the Bureau of Consumer Services, the Bureau of Safety and Compliance or other Bureaus of the Commission from performing their duties and making recommendations, including recommendations regarding fines, for failure of T. W. Phillips to perform in any of the areas contained in "Appendix C."

G. PLANT INVESTMENT COMMITMENT

49. T. W. Phillips commits to make the minimum cumulative capital investments in plant of \$36 million for calendar years 2012 through 2014. This represents an approximately 38% increase above the average historic level of investment of \$8.7 million per year for the three years ending December 31, 2010, excluding investments for the Rubright Interconnection.³ T. W. Phillips agrees that the capital investment will be designed to improve safety and reliability of service such as the removal of bare steel and aging infrastructure, reduce lost and unaccounted for gas, and improve customer service. T. W. Phillips further commits that it will increase its investment in replacement of bare steel and aging infrastructure above the average historic level of approximately \$4.6 million per year for the three years ending December 31,

³ The Rubright Interconnection was a project undertaken to construct facilities including a compressor, that enables T. W. Phillips to inject local Pennsylvania production into interstate storage capacity held by T. W. Phillips on Dominion Transmission Company, for use by T. W. Phillips to serve its customers in winter months.

2010 by dedicating at least 50% of the incremental cumulative capital investments in excess of \$8.7 million to replacement of bare steel and aging infrastructure. The capital needed to make such investments will be provided by internally generated funds, additional debt issuances by T. W. Phillips and contributions of capital by Holdings II, maintaining approximately a 50%/50% debt/equity ratio at T. W. Phillips. If authorized by statute, T. W. Phillips may request a DSIC to become effective after January 1, 2013. All Signatory Parties reserve their rights to address all issues related to this request.

H. UNIVERSAL SERVICE

50. T. W. Phillips will evaluate the need for improvements and potential expansion of its Universal Service programs. T. W. Phillips will continue to fund its Universal Service programs consistent with its needs analysis prepared using the same procedures that were used to develop the needs analysis that was presented in conjunction with its 2010 base rate case and will adhere to the commitments made in the Settlement of its 2010 base rate case at Docket No. R-2010-2167797.

51. Except as provided in this section, T. W. Phillips will be permitted to recover Universal Service costs under T. W. Phillips' existing recovery mechanism, Rider USP-Universal Service Program. T. W. Phillips may propose changes to the recovery mechanism, which any Signatory Party to the Settlement may oppose, for review by the Commission. Nothing in this Settlement shall be construed to alter the settlement reached in *Pennsylvania Public Utility Commission v. T. W. Phillips Gas and Oil Co.*, Docket No. R-2010-2167797, related to Rider USP.

52. Commencing January 1, 2012, T. W. Phillips' shareholders will support an increase in the current funding for T. W. Phillips' Low Income Usage Reduction Program

("LIURP") of \$10,000 per year until the effective date of rates in T. W. Phillips' next base rate case. Any funds not used in one year will roll over to the next year. This \$10,000 per year is not recoverable through Rider USP.

53. T. W. Phillips will contribute to the Dollar Energy Fund a minimum of \$35,000 of shareholder funds annually for three years commencing January 1, 2012. If customer contributions exceed \$35,000, T. W. Phillips will match the customer contributions. T. W. Phillips will also provide at least \$15,000 annually in administrative funds for a three-year period commencing January 1, 2012. T. W. Phillips will review possible ways to increase outreach to customers to attempt to increase customer contributions and will provide a report to the Commission and OCA. T. W. Phillips will also continue its charitable contribution to BERI (Butler County Emergency Relief Initiative - United Way of Butler County) of a minimum of \$5,000 per year for the three years commencing January 1, 2012, in support of efforts to provide assistance to T. W. Phillips' customers. The contributions referred to in this paragraph will be funded by T. W. Phillips' shareholders and are not recoverable through Rider USP.

I. COMMUNITY COMMITMENT

54. For a period of not less than five years, T. W. Phillips will provide annual corporate contributions and community support in southwestern Pennsylvania in a total amount of at least \$15,000.

55. T. W. Phillips will maintain a diversity program in compliance with the Commission's diversity policy, 52 Pa. Code §§ 69.801-69.809.

J. GAS PURCHASING AND INTERCONNECTIONS

56. T. W. Phillips will retain adequate gas supply procurement personnel on staff unless the Commission approves provision of such services through a service corporation. T. W. Phillips will include these individuals among its expert witnesses in its 1307(f) proceedings.

57. T. W. Phillips will comply with the Commission-approved 1307(f) plan current at the time of closing.

58. T. W. Phillips will not establish new interconnections with Peoples without prior Commission approval pursuant to Chapter 21 of the Public Utility Code. Each proposed interconnection may be approved by the Commission only if T. W. Phillips demonstrates: (1) that each interconnection will not reduce the availability of local gas to T. W. Phillips' customers that is required to meet a least cost procurement policy; (2) will produce no harm to T. W. Phillips' customers including the consideration of costs to establish any interconnections; and (3) will produce net benefits for Peoples' customers.

59. T. W. Phillips and Peoples will evaluate the merits of any interconnection between the companies independently. All Signatory Parties reserve their right to address all issues related to a request for approval of an interconnection.

K. RETAIL SUPPLY COMPETITION

60. T. W. Phillips will convene a collaborative conference with interested parties, including OCA, OTS, OSBA and interested natural gas suppliers and customers, within 12 months of closing in order to develop a strategy to promote retail natural gas supply competition.

61. T. W. Phillips will review policies of Peoples with regard to "Customer Choice" and meet with Peoples to develop procedures to assist in the creation of a small customer transportation "Choice" program on T. W. Phillips' system. T. W. Phillips will develop rules

and practices that are, to the extent permissible by operation of its system, consistent with those of Peoples to encourage participation in the "Choice" programs by marketers on both systems.

L. LOST AND UNACCOUNTED FOR GAS

62. Following the closing, Holdings II and T. W. Phillips will evaluate and examine T. W. Phillips' system and the Commission's findings in T. W. Phillips' 2010 1307(f) proceeding and T. W. Phillips' 2011 1307(f) proceeding to identify options to reduce Lost and Unaccounted For Gas ("UFG"). T. W. Phillips and Peoples will collaborate to identify and use best practices to reduce UFG on their systems. Nothing in Paragraphs 62 or 63 is intended to change T. W. Phillips' burden of proof regarding LUFG in future 1307(f) proceedings or to prohibit other parties from challenging recovery of LUFG-related costs in future 1307(f) proceedings.

63. T. W. Phillips will present a report to OSBA, OTS, OCA, PIOGA and TWPLUG with regard to the results of such investigation no later than the filing of testimony in T. W. Phillips' 2012 1307(f) proceeding.

M. MISCELLANEOUS

64. The Signatory Parties stipulate that for ratemaking purposes, deferred taxes will be per T. W. Phillips' books as calculated under federal normalization rules (and reflecting the appropriate deferred tax elements for ratemaking purposes such as taxes associated with Contributions in Aid of Construction ("CIAC")) and no Signatory Party will propose or support an adjustment to this treatment related to this acquisition.

65. Peoples and T. W. Phillips and their respective direct and indirect parents will examine whether creation of a service corporation to provide services to both companies is in the best interests of their respective customers. The companies will report to OTS, OCA and OSBA

with regard to their conclusions within 24 months after the closing. T. W. Phillips and Peoples will obtain affiliated interest agreement approval from the Commission prior to implementation of a service corporation. All Signatory Parties reserve their rights to address all issues related to such filing.

66. This Settlement is conditioned upon the Commission's granting of all necessary approvals for the acquisition and all proposed changes in corporate structure including the conversion of T. W. Phillips to an LLC by merger into a new corporation under Pennsylvania law.

67. T. W. Phillips agrees to join with OTS, OCA, and OSBA, in a request to be made by separate filing, that the Commission (a) initiate within six months of such request a generic investigation or rulemaking to address whether Natural Gas Distribution Company ("NGDC") to NGDC competition should be permitted to continue and, if permitted to continue, under what circumstances it will be considered appropriate, and (b) proceed expeditiously to conclude such investigation or rulemaking. Other Signatory Parties and any other party not a signatory to the Settlement reserve the right to challenge the necessity for any such investigation or rulemaking. The Signatory Parties acknowledge and agree that the terms and conditions of this Settlement are in no way conditioned upon the Commission commencing the requested generic investigation or rulemaking, and that the Signatory Parties will continue to support fully the remaining terms and conditions of this Settlement notwithstanding whether the Commission commences the requested generic investigation or rulemaking.

68. T. W. Phillips and Peoples will not blend or consolidate their Purchased Gas Cost ("PGC") rates or their distribution rates unless the companies first obtain a certificate of public convenience to merge the two NGDCs. Nothing herein shall prohibit T. W. Phillips and Peoples

from obtaining services from the same service corporation, provided that the Commission approves the necessary affiliated interest agreement(s) pursuant to Chapter 21 of the Public Utility Code; and provided further that the recovery by T. W. Phillips and Peoples of the costs paid to that service corporation shall meet the standards prescribed by Chapter 21.

IV. THE SETTLEMENT IS IN THE PUBLIC INTEREST

69. Commission policy promotes settlements. *See* 52 Pa. Code § 5.231. Settlements lessen the time and expense the parties must expend litigating a case and, at the same time, conserve precious administrative resources. The Commission has indicated that settlement results are often preferable to those achieved at the conclusion of a fully litigated proceeding. *See id.* § 69.401. In order to accept a settlement, the Commission must first determine that the proposed terms and conditions are in the public interest. *Pa. Pub. Util. Comm'n v. York Water Co.*, Docket No. R-00049165 (Order entered Oct. 4, 2004); *Pa. Pub. Util. Comm'n v. C.S. Water and Sewer Assocs.*, 74 Pa. P.U.C. 767 (1991). As will be detailed in the Signatory Parties' Statements in Support of Settlement, the instant Settlement is in the public interest because, with the conditions imposed herein, the Proposed Transaction will provide substantial affirmative public benefits.

70. Approval of the Settlement will lessen the time and expenses that the Signatory Parties, and the Commission, must expend on the proceedings.

71. There were no customer protests against the Joint Application. The Settlement resolves all issues in the instant proceeding between the Signatory Parties.

72. The Signatory Parties will further supplement the reasons that the Settlement is in the public interest in their Statements in Support of Settlement, which are attached hereto as

“Appendices D through H.” Attached as **“Appendix I”** is a letter from TWPLUG indicating that it neither supports nor opposes this Settlement.

V. CONDITIONS OF THE SETTLEMENT

73. The Settlement is conditioned upon the Commission’s approval of the terms and conditions contained in this Settlement without modification. If the Commission modifies the Settlement, any Signatory Party may elect to withdraw from the Settlement and may proceed with litigation and, in such event, the Settlement shall be void and of no effect. Such election to withdraw must be made in writing, filed with the Secretary of the Commission and served upon all Signatory Parties within five (5) business days after the entry of an Order modifying the Settlement.

74. This Settlement is proposed by the Signatory Parties to settle all issues in the instant proceeding. If the Commission does not approve the Settlement and the proceedings continue, the Signatory Parties reserve their respective procedural rights to evidentiary hearings, submission of additional testimony and exhibits, cross-examination of witnesses, briefing, and argument of their respective positions. The Settlement is made without any admission against, or prejudice to, any position that any Signatory Party may adopt in the event of any subsequent litigation of these proceedings, or in any other proceeding.

75. The Signatory Parties acknowledge that the Settlement reflects a compromise of competing positions and does not necessarily reflect any Signatory Party’s position with respect to any issues raised in this proceeding. This Settlement may not be cited as precedent in any future proceeding, except to the extent required to implement this Settlement.

76. If the ALJs adopt the Settlement without modification, the Signatory Parties waive their right to file Exceptions.

VI. CONCLUSION

WHEREFORE, T. W. Phillips Gas and Oil Co., TWP INC., LDC Holdings II LLC, the Office of Trial Staff, the Office of Consumer Advocate, the Office of Small Business Advocate, and the Pennsylvania Independent Oil and Gas Association, by their respective counsel, respectfully request as follows:

(a) That the Honorable Administrative Law Judges David A. Salapa and Conrad A. Johnson recommend approval of, and the Commission approve, this Joint Petition for Approval of Settlement including all terms and conditions thereof without modification; and,

(b) That the Commission issue certificates of public convenience evidencing approval under Section 1102(a)(3) of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 1102(a)(3), of the acquisition by transfer of all of the issued and outstanding shares of common stock of T. W. Phillips Gas and Oil Co., currently owned by TWP INC., to LDC Holdings II LLC, an indirect subsidiary of SteelRiver Infrastructure Fund North America LP, and approval of the resulting change in control of T. W. Phillips Gas and Oil Co., and further that the Commission authorize the conversion of T. W. Phillips Gas and Oil Co. to an LLC by merger into a new corporation under Pennsylvania Law.

**PUBLIC SERVICE COMMISSION
OF WEST VIRGINIA
CHARLESTON**

At a session of the PUBLIC SERVICE COMMISSION OF WEST VIRGINIA in the City of Charleston on the 22nd day of December 2009.

CASE NO. 08-1761-G-PC

HOPE GAS, INC., dba DOMINION HOPE,
DOMINION RESOURCES, INC., and
PEOPLES HOPE GAS COMPANIES, LLC,

Joint petition for consent and
approval of the purchase and sale of
the common stock of Hope Gas, Inc.,
and related relief.

COMMISSION ORDER

For the reasons set forth in this Order, the Commission disapproves the Application requesting prior approval to the proposed sale of Hope Gas, Inc. ("Hope") to Peoples Hope Gas Companies, LLC ("PH Gas"), ("Sale Case"). PH Gas, the buyer, has insisted that as a condition to approval of the sale that it receive an immediate tariff rate increase solely attributable to this sale which is not offset by benefits. Therefore, approval would adversely affect the public in this State.

I. INTRODUCTION

The Commission has before it the remainder of what was originally two consolidated cases in West Virginia, the Hope Gas Rate Case filed on October 16, 2008 ("Rate Case"), and the Sale Case by Dominion Resources filed on October 14, 2008, involving the proposed sale of its West Virginia gas utility operations to SteelRiver Infrastructure Fund North America, LP ("SRI"). The Rate Case was resolved by an Order of this Commission entered November 20, 2009, that awarded Hope Gas a rate increase, based on its operations as a going-forward entity as it currently exists, of \$8,784,224 ("Rate Order").

The Sale Case is the subject of this Order. More specifically, on October 14, 2008, Hope, Dominion Resources, Inc. ("Dominion"), and PH Gas (together with Dominion "Applicants") petitioned for leave to transfer all of the common stock owned by Dominion in Hope to PH Gas. PH Gas was formed to hold the common stock of Hope and its sister company, Peoples Natural Gas Company ("Peoples"). PH Gas, in turn, will be owned by a series of holding companies controlled by SRI. SRI is an investment fund with capital

provided from a variety of pension funds based in North America and Europe. Under the July 1, 2008 Sales Purchase Agreement ("SPA"), SRI has agreed to pay \$149 million in cash and will acquire \$70 million in debt, for a total cost of \$230 million for the Hope common stock.

Subsequent to filing the Sale Case in this docket, Hope initiated the Rate Case on October 16, 2008, seeking additional revenue of \$34.4 million for furnishing natural gas to 114,000 customers in 32 West Virginia counties. Hope Tariff Filing. Hope subsequently moved to consolidate the Rate Case with the Sale Case. November 10, 2008 Motion to Consolidate.

On January 20, 2009, the Commission consolidated the Rate Case and Sale Case, set a procedural schedule and extended the suspension period for the Rate Case.

On November 20, 2009, the Commission issued a final Order in the Rate Case that severed the consolidated matters, ruled on the outstanding Rate Case issues insofar as Hope's operations as a stand-alone entity are concerned, granted Hope \$8,784,224 in additional revenues and deferred ruling on the Sale Case. The Rate Case order also included a more complete procedural history of the combined cases in its Appendix A. The complete final Order and the related procedural history is available on the Commission's website at:

<http://www.psc.state.wv.us/scripts/webdocket/viewdocument.cfm?caseactivityid=284155>

As indicated, the Sale Case for Hope's West Virginia operations is only part of the proposed purchase/sale transaction by Dominion and SRI. There was also a sale case filed before the Pennsylvania Public Utility Commission ("PaPUC") for the sale of Dominion's Pennsylvania gas utility operations; in fact, the portion of the transaction involving the sale of the Pennsylvania gas utility operation constitutes the lion's share of the overall proposed transaction. The proposed purchase price for the Pennsylvania operation is approximately \$736 million of a total transaction cost estimated at \$945 million.

Dominion and SRI negotiated the structure of the proposed transaction, including the decision to make the two sales dependent on approval in both Pennsylvania and West Virginia; determined how and when to file the transactions for approval before this Commission and PaPUC; and made the critical decisions on when and how to attempt to resolve, stipulate or offer concessions on issues in the proceedings pending in both West Virginia and Pennsylvania.

On November 19, 2009, only one day before this Commission was required by statute to enter its Order in the Rate Case, the PaPUC entered an Order rejecting the earlier decision of the PaPUC Administrative Law Judge ("ALJ") to disapprove the proposed settlement in Pennsylvania for the sale of Peoples. PaPUC reviewed the transaction, concluded that the ALJ was incorrect in its analysis of the benefits presented by the settlement and approved the sale, subject to an array of conditions imposed in that settlement and the PaPUC Order.

We are sensitive to the action of PaPUC in approving the sale and respectful of the decision of PaPUC to approve the stipulation; we are, however, bound by our statutes and precedent and must assess the Sale Case under controlling West Virginia law and precedents and the record presented in this case. Further, unlike the PaPUC, and as we mentioned in our Rate Case Order, we have no stipulation before us in the Sale Case that has been negotiated among and approved by nearly all of the parties. Rate Case Order at 3. Instead, we have an awkward procedural development in which Dominion and SRI have tendered what amount to ongoing unilateral conditions and commitments, and in its submittal, SRI, for example, states that the Dominion proposal by itself is insufficient. SRI continues to insist upon a proposed increase to customer rates as part of its proposed conditions. As late as the close of business on December 15, 2009, SRI tendered a "Response of Peoples Hope Gas Companies, LLC to Filing of Other Parties of December 9, 2009, December 10, 2009 and December 14, 2009." Not only have Dominion and SRI failed to submit an agreement as between them, but just as clearly they have not caught the interest of the Staff, CAD, IOGA or the Union intervenors, who continue to raise what they perceive as serious and sustained objections and opposition to the transaction.

The Sale and Rate Cases, through procedural development, discovery, filings, and evolution to this point, have been hotly-contested, difficult, complex and interrelated. At the same time, however, when all is said and done, the decision faced by this Commission of whether to approve the Sale Case is relatively simple to state (and actually not all that mysterious or surprising in its result).

As we will discuss more fully in this Order, our belief is that the sale, in and of itself and as currently structured and insisted upon by Dominion and SRI, has terms and conditions that are not reasonable and that result in a significant adverse effect on the public in this State by creating an ownership and operating structure that will, solely and directly as a result of the nature and structure of the transaction, increase rates to West Virginia customers without the corresponding and offsetting benefits that might justify such an increase in a purchase and sale case.

As can be seen by the following procedural history and discussion of the case, SRI and Dominion have not reached an accord between themselves on how the Sale Case should be resolved, let alone convinced the other parties or this Commission that the proposed sale is in the public interest and that it will not adversely affect the public in this State.

II. PROCEDURAL BACKGROUND

At the time of the filing of the Sale Case on October 14, 2008, the Commission's Consumer Advocate Division ("CAD"), filed to intervene, arguing that these cases are proceedings with potential adverse effects on ratepayers.

On October 29, 2008, the Independent Oil and Gas Association of West Virginia, Inc. ("IOGA"), requested to intervene.

On November 12, 2008, the Utility Workers Union of America Local 69-2 ("Union") requested to intervene in both proceedings to advocate for its membership.

On November 18, 2008, Staff filed an Initial Memorandum in the Sale Case stating that it did not object to the earlier motion to consolidate the Sale and the Rate Cases if the Commission did not reduce the time-frame of the consolidated matter.

On January 2, 2009, the West Virginia Community Action Partnership moved to intervene in these matters.

The Commission subsequently consolidated the Sale Case and Rate Case and fixed an appropriate procedural schedule originally designed to process the cases in an expedited fashion. January 20, 2009 Commission Order.

After the January 20, 2009 Order, the parties engaged in extensive discovery. CAD, Staff and IOGA propounded numerous requests for documents to both Hope and PH Gas. The parties participating in discovery signed interim protective agreements to allow an unimpeded flow of discovery documents.

On April 24, 2009, all parties other than the Applicants prefiled their direct testimony.

On June 1, 2009, the parties appeared before the Commission for an evidentiary hearing in both cases. In response to a question from the Commission, the parties decided that it would be appropriate to pursue efforts toward a negotiated resolution of the two cases and requested that the Commission amend the procedural schedule. The parties requested that the Commission delay the evidentiary hearing until August 17, 2009, and further toll the suspension period for the Rate Case through November 20, 2009. The parties also suggested that the Commission direct preparation of expedited transcripts and suggested a briefing schedule.

On July 23, 2009, the Commission, in an effort to assist the parties in sharpening or defining the issues between them, ordered the parties to provide a list of the contested and stipulated issues, if any, in this matter on or before August 3, 2009. Commission Order of July 23, 2009, at 3. The parties subsequently filed lists as directed.

Notwithstanding the additional time to attempt to narrow or stipulate some or all of the issues among them, the parties were unsuccessful, and on August 17-24, 2009, the Commission conducted an evidentiary hearing. The parties presented their respective positions regarding both the Sale Case and the Rate Case. At the hearing, and over the objection of the other parties, Dominion offered by way of a "unilateral commitment" to provide a credit of \$8,667,248 to reduce revenue requirements and rates for Hope customers

conditioned on the transaction in this matter closing on or before December 31, 2009. Transcript of the August 17, 2009 Commission Hearing at 22-25. Other parties also introduced testimony regarding the sale into evidence.

On September 24, 2009, the parties submitted initial briefs in support of their positions. CAD also filed revisions to its revenue requirement calculations. PH Gas filed a proposed final Order. Those parties also filed reply briefs on October 5, 2009.

On October 20, 2009, CAD moved to supplement the record to include an order issued by an ALJ in the parallel sale proceeding before the PaPUC. The PaPUC ALJ rejected a proposed settlement of the Pennsylvania sale case. There was no rate case filed in Pennsylvania as a part of the proposed sale of the Pennsylvania gas operations.

On October 21, 2009, Hope requested to supplement the record before this Commission with documents Dominion filed in response to the disapproval by the Pennsylvania ALJ of the proposed settlement of the Pennsylvania sale case.

The PaPUC issued an order on November 19, 2009, that examined the decision of the Pennsylvania ALJ under Pennsylvania case law and standards and concluded that it should approve the Joint Stipulation in Pennsylvania, as modified by the conditions imposed by the PaPUC in that Order.

On November 20, 2009, the Commission issued an order in the Rate Case granting Hope an additional revenue requirement of \$8,784,224 based solely upon Hope's cost of doing business under its present ownership. The Rate Order severed the Sale Case from the Rate Case, noting that the PaPUC's decision was based on the stipulation of most of the parties to the Pennsylvania proceeding and observing that no such stipulation existed in West Virginia. The Commission advised the parties that this Commission would issue a separate order regarding the Sale Case in this proceeding as soon as possible.

The Commission subsequently directed that the parties present any proposed settlement in this matter on or before December 11, 2009. November 23, 2009 Commission Order.

On December 2, 2009, before the expiration of the December 11, 2009 stipulation deadline, Dominion filed a document in response to the November 23, 2009 Commission Order representing that the parties would not achieve a joint settlement of all issues and unilaterally offering an amendment to its own earlier conditional rate credit. Dominion offered to tender \$27 million into an escrow account exclusively for Hope ratepayers, but conditioned that offer on a requirement that the closing of the sale occur on or before December 31, 2009. Dominion also noted that, although it was looking for a closing on or before December 31, 2009, it would actually require a final Commission order in this matter on or before December 22, 2009, in order to assure a timely closing by year end December 31, 2009.

SRI did not join in the December 2, 2009 proposal from Dominion, but on December 3, 2009, SRI filed a separate response offering to submit additional conditions.

Given the apparent termination of settlement discussions and that SRI and Dominion were apparently not able to work out their individual approaches with the other parties, the Commission directed all parties, other than Dominion, to respond to the December 2, 2009 Dominion filing to address the economic impact of the revised Dominion proposal or other comments on or before December 9, 2009.

On December 8, 2009, PH Gas responded to the December 2, 2009 Dominion filing. PH Gas suggested establishing an irrevocable trust to manage the rate credit and to forward monthly payments to Hope until exhausted. PH Gas also proposed new additions to its prior sale conditions in Joint Exhibit 4 and Exhibit CPK-8, including limits on dividends, a local senior Hope manager, and an estimate that its rate base will increase after closing. PH Gas also proposed that the Commission authorize an immediate additional tariff rate increase of \$7.2 million to compensate for the rate base increase. PH Gas Conditions filed December 8, 2009 ("PHG Conditions").

On December 9, 2009, CAD, Staff and the Union responded to the December 2, 2009 Dominion filing. All of the intervenors noted substantive flaws in the SPA and the conditions proposed by the Applicants.

Staff and CAD confirmed that rates as a result of the sale would increase by at least \$7.2 million under SRI ownership, but noted that rates need not increase immediately. CAD Response at 4, Staff Response at 3, 5. IOGA and CAD also continued to warn the Commission against outsourcing gas procurement to a third party. CAD Response at 8, IOGA Response at 2, 3. CAD also recalculated its estimate of the lost accumulated deferred income taxes ("ADIT") as \$28.4 million and noted the lost "other post-employment benefit" ("OPEB") prepayments and regulatory liability balances due to the sale transaction, prompting a recommendation by CAD that the Commission require Dominion to increase the rate credit escrow to \$50 million. CAD Response at 3, 4. CAD subsequently filed a statement on December 14, 2009, that indicated that it was unable to precisely quantify the amount of financial detriment but reaffirmed that the amount exceeded the \$27 million rate credit escrow. Finally, the Union noted its concern that the existing Dominion offer fails to address the post-sale viability of Hope and the impact that might have on West Virginia gas producers.

On December 10, 2009, Dominion replied to the CAD and Staff filings arguing that CAD overstated the rate base impact of the proposed sale and asserting that it will not substantially profit from the sale in its current form.

On December 14, 2009, Staff supplemented its December 9, 2009 filing and recommended changes to proposed SRI conditions of debt levels and field taps. Staff also expressed concern that several conditions are less strenuous than the statutory requirements

of W.Va Code §24-2-12. Finally, Staff continued to object to any rate increase absent a new rate proceeding.

On December 15, 2009, SRI filed a new set of modified conditions for the transaction. SRI incorporated several suggestions from other parties including language regarding debt levels and field taps. SRI also committed to refrain from outsourcing gas procurement after completion of the Transition Services Agreement ("TSA"). SRI continued to object to a deferral of the rate increase issue to a future rate case, and instead insists that an immediate rate increase above the currently approved Hope rates should be granted as a condition of the sale approval. December 15, 2009 SRI Filing at 7-8.

III. TESTIMONY AND DISCUSSION

A. In General

On July 1, 2008, Dominion and SRI executed the SPA to purchase all the common stock of Hope and its affiliate corporation, Peoples, for a base sale price of \$910,485,014, adjusted by working capital and certain other conditions. SPA at 10-11. Of that amount, approximately \$149 million reflects the purchase price for Hope and another \$70 million is earmarked to replace the debt portion of the Hope capital structure. Petition at 15. The Applicants, for their own reasons, have structured the transaction in a manner that requires regulatory approval from both this Commission and the PaPUC, commits the parties to an election under 26 U.S.C. §338(h)(10) to treat the transaction as an asset sale for tax purposes ("§338 Election") and specifies that a party may abandon the agreement after December 31, 2009. SPA at 13, 45-47.

Along with the SPA, the parties entered into the TSA obligating Dominion to continue to provide services to Hope for up to eighteen months after closing of the SPA. *Id.* and Transcript of August 17, 2009 Commission Hearing ("Tr.") at 22. In addition to the SPA and the TSA, the Applicants presented other associated agreements in support of the transaction including a shared facilities agreement, agreements to maintain existing facilities on Dominion Transmission Inc. ("DTI") properties, and to lease communications equipment. Sale Application App. A-H.

While the Commission cannot dictate, and does not require, that parties settle, in complex sales cases such as these, it has been the experience of the Commission that negotiated solutions arrived at by arms-length negotiations among the parties are typically preferable to an attempt to litigate. The Commission has from time to time advised the Applicants of the wisdom of seriously pursuing a negotiated agreement. Unfortunately, the current posture of the case presents the Commission with competing sets of conditions from parties and no consensus agreement. It is clear from the record that not even Dominion and SRI can agree on reasonable conditions that should be placed on the sale in order to offset negative impacts on West Virginia. *See*, December 9, 2009 CAD Response at 6. The apparent lack of agreement, if not straight-out public disagreement between Dominion and

SRI is surprising, and places the Commission in the difficult, if not impossible, position of attempting to fashion and impose conditions on the parties in order to close the transaction that the parties to this proceeding seem unable and unwilling to reach on their own.

The Commission believes that one of the primary indicia for the "adverse impact on the public" that results from any proposed acquisition is whether the transaction, in and of itself and without corresponding benefits or other adequate reasons, will result in a rate increase to the customers. In these consolidated cases, Hope Gas received by virtue of the November 20, 2009 Rate Order, a rate increase of \$8,784,224. Additionally, even though Hope received those additional revenues in the Rate Case on November 20, 2009, SRI has requested an immediate and additional \$7.2 million tariff rate increase arising solely from the sale, including significant structuring of the sale that is within the control of Dominion and SRI. Although the immediate impact on customers' bills can be offset by the rate credit escrow funds offered by Dominion, that offset will be of limited duration and there will be an eventual increase in customer bills due solely to the sale. In and of itself, without significant and substantial offsetting benefits to the customers and the State, this rate impact constitutes sufficient adverse public effect to require the Commission to determine that the sale is contrary to the public interest.

There are other matters beyond the rate impact raised by various parties which make the proposed sale of Hope's West Virginia gas operations to SRI questionable. In a typical utility sale proceeding where both the buyer and seller have a satisfactory track history with which the Commission is familiar or that is available for review and inquiry, the Commission can focus on that track history to assess the likelihood of satisfactory service after the sale to the buyer.

In a sale to a buyer with a solid record of performance and experience operating utility systems, the Commission typically looks to the seller for the limited purposes of determining that the seller wants to sell, that the seller is not withholding or concealing assets that are essential for the buyer to render quality service and that the transaction otherwise meets the tests of W.Va. Code §24-2-12

The intervenors allege in this matter, however, that Dominion will retain assets and skills that are necessary to operate Hope after closing and that SRI may not come to the transaction with sufficient skills and assets to overcome that problem. Therefore, the Commission is obligated to consider the skills lost by Hope due to the sale and scrutinize the proposed management under SRI. In addition to this issue, and as more fully discussed below, the Commission is concerned with the adverse impact of an immediate tariff rate increase. Even factoring in the commitments that appear to be offered by SRI and the effect of the conditional rate credit offered by Dominion, the Commission still believes that the transaction adversely affects the public in this state by imposing higher revenue requirements that will ultimately translate into higher rates for Hope customers solely as a result of the transaction.

B. Statutory Standard

The Legislature created the Commission to exercise regulatory authority over public utilities in this state. It is charged with the duty to ensure fair regulation in the interest of the consuming public while balancing the availability of utilities and the productive use of energy resources. W.Va. Code §24-1-1(a). The Commission may grant its prior consent for the acquisition of the majority of the common stock in any public utility organized and doing business in this state under three conditions. The Applicants must show that (i) the terms and conditions of the transaction are reasonable, (ii) neither party to the transaction has an undue advantage over the other and (iii) the transaction does not adversely affect the public in this state. The Commission is also empowered to attach conditions that it deems proper to the transaction. Without this prior Commission consent, the transaction is void to the extent that the interests of the public in this state are adversely affected. W.Va. Code §24-2-12.

The Commission has also interpreted W.Va. Code §24-2-12 to require, as an incident of that three-part test, a showing that the buyer, SRI, has, or as a result of the transaction will obtain, the knowledge, experience and resources that allow it to conduct operations that provide adequate and reliable service at reasonable rates. Hope Gas Inc., Case No. 99-0462-G-PC (Commission Order, July 27, 1999).

C. Undue Advantage

One of the three conditions under W.Va. Code §24-2-12 described above proscribes any party to the transaction from having an undue advantage over the other. The failure to meet this requirement has rarely been asserted in any substantial sale of a public utility in this state.

After the failure of a prior attempt to sell Hope to Equitable Gas Company, Dominion conducted an auction for both Hope and Peoples. See, Case No. 06-0441-G-PC and Hope Ex. 5 at 3, 6. That auction resulted in selection of SRI as the winning bidder. Evidence before the Commission shows no substantial connection between Dominion and SRI outside of the SPA, and the Commission will assume the existence of good faith, arms-length negotiations between Dominion and SRI. Id. Therefore, the Commission concludes that neither party to the transaction has an undue advantage over the other.

D. Terms and Conditions and Adverse Impacts

The other two tests for evaluating utility agreements under W.Va. Code §24-2-12 require the Commission evaluate and assess whether the terms and conditions of the transaction are reasonable and whether the transaction adversely affects the public in this state. These two conditions are in a sense intertwined, and it is difficult to see how unreasonable terms and conditions would not adversely affect the public in this state. While this test is an attempt to assess the transaction as structured, it also has a "forward-looking"

element to it and requires that the Commission evaluate how the new utility will function after the transaction is closed.

In their testimony, Staff, CAD and IOGA raised various concerns and reservations regarding the terms of the SPA. They reiterated those concerns in the December 9-14, 2009 filings. The adverse impacts asserted by the intervenors are the (i) negative financial impacts from the sale and (ii) the apparent lack of managerial capacity of SRI that prevents it from effectively and efficiently operating Hope. Those intervenors suggested other possible concerns and requested that additional conditions be placed on the transaction. The Commission, however, does not believe that it needs to address these conditions because it finds that the weaknesses in the following two primary areas cause an adverse impact on the public in this state.

1. Dominion Conditional Rate Credit

In its prefiled direct and rebuttal testimony, neither Dominion nor SRI advanced the need for any rate credits or rate considerations other than the approval of the transaction as contemplated by the SPA. As the hearing progressed, Dominion changed its position and unilaterally offered a conditional rate credit for Hope customers in the amount of \$8,667,248 as an incentive for approval of the SPA on or before December 31, 2009. Tr. at 22-25. Arguably, this credit was designed to offset the negative rate impacts expected as a result of SRI's acquisition of Hope. Dominion initially structured the credit as a reimbursement of services provided under the TSA up to the amount offered. In the event that the total services provided under the TSA did not reach that amount, Dominion pledged to tender the difference in cash to be used as a rate credit. Dominion also requested that the Commission amend the Hope tariff to make provision for the rate credit. *Id.* When the Commission severed this matter from the Hope rate proceeding, it deferred consideration of the offered rate credit. Rate Order at 3.

On December 2, 2009, and without any indication by the Commission of its view on the earlier "conditional rate credit," Dominion amended its conditional services reimbursement/rate credit offer and increased the figure from approximately \$8.67 million to a total rate credit of \$27 million. Dominion also restructured its offer to provide for deposit of the total credit into an escrow account instead of a refund of TSA charges. SRI acknowledged the enhanced offer on December 3, 2009, and subsequently submitted separate additional conditions to supplement its initial proposals in Exhibit CPK-8 and Joint Exhibit 4, including establishing a trust to hold funds for rate credit. PHG Conditions. Staff and CAD basically reiterated their positions in the December 9, 2009 responses, but CAD also recommended a credit of at least \$50 million, a figure representing an estimate from CAD of the present value of the total adverse rate impact from the transaction over time.

After review of the revised Dominion offer and the analysis from other parties to this matter, the Commission will consider the conditional rate credit as a component of the

proposed sale in its analysis of the SPA. That credit, however, is a finite resource that is facially incapable of compensating for continuing financial detriments as described below.

2. Financial Impacts

The most contentious aspect of the proposed sale is the financial impact resulting from the SPA and its potential effects on Hope ratepayers. The intervenors to this matter raised what they viewed as several financial detriments from the sale including (i) the increased rate base due to the §338 Election, (ii) increased cost from other rate base changes, (iii) loss of historic benefits from a consolidated tax filing, (iv) loss of bonus depreciation and (v) higher cost of capital. After considering these impacts and factoring in both the revised conditional rate credit from Dominion and the request for \$7.2 million in additional rates from SRI, the Commission finds that the financial considerations will result in an adverse affect on the public of this state for the foreseeable future, well beyond the exhaustion of the conditional rate credit trust account offered by Dominion.

a. §338 Election

The first negative financial consideration raised by the intervenors is the election by Dominion and SRI to treat the stock sale as an asset sale for income tax purposes under the Internal Revenue Code, generally known as a §338 Election. The parties to the transaction are the entities that negotiated, acquiesced to or insisted upon the §338 Election. The net effect of the §338 Election is to treat a stock sale as an asset sale under §338 of the Internal Revenue Code. The §338 Election results, however, in a reversal of all ADITs and the establishment of a new cost basis (rate base) for all affected Hope assets. After the sale, Hope will again take higher levels of accelerated depreciation against the basis of its assets and start to accumulate a new ADIT balance. PH Gas Ex. JIW-D at 6-9. The new balance, however, will take many years to equal the current balances. See, CAD Ex. 10 at 1-2. More importantly, a build-up of "new" ADIT balances does not come without cost to the customers because it requires customers to fund these balances by inclusion of deferred income taxes in rates. Eliminating the current ADIT balance affects ratepayers immediately because the ADIT balance acts to lower the rate base. The additional revenue requirement due to increased rate base is apparently a significant portion of the additional revenue that SRI insists that it needs in the case, above the \$8,784,224 already awarded to Hope in the Rate Case. PH Gas Ex. JIW-D at 6-9 and PHG Conditions at App. A.

In that recent Hope rate case, the rate base was calculated without regard to the sale, but subsequent rate cases will include a reduced ADIT balance. Rate Order at 23. Using the initial CAD estimate, the increased revenue requirement impact of this reduced ADIT balance amounts to a present value of at least \$12 million. See, CAD Ex. 9 at 29 and CAD Ex. 7 at 49. CAD subsequently revised that estimated rate base change upward. Dominion, however, disputes the CAD estimates. SRI estimated an increased rate base of \$23 million attributable to the §338 Election in the first year following closing. PHG Conditions at App. A. While it is difficult to make an exact calculation, the Commission estimates that the total financial

impact of the §338 Election will endure for a significant period of time. Even if the \$23 million rate base impact would eventually be reduced to zero, the present value of the increased revenue requirement will be significant and will certainly approach or exceed CAD's estimate of \$12 million. Therefore, the Commission finds that the §338 Election, an election solely for the benefit of the parties, is a material adverse impact that will solely and directly cause higher revenue requirements for Hope customers for the foreseeable future.

b. OPEB, Pension and Other Rate Base Changes

A second series of financial impacts arising from the proposed transaction is the effect on rate base from the pension division, the loss of OPEB credits to rate base and possibly the elimination of the regulatory liability created when tax rates were reduced in the past. Appendix A to PHG Conditions and Rate Order at 23, 24. Staff calculated the OPEB rate base change to be nearly \$30 million. Staff Ex. 6B at 5-6. The SRI calculation also eliminated the \$4 million regulatory liability taken as a rate base reduction by the Commission although Dominion disputed that part of the SRI calculation. PHG Conditions Appendix. A and Dominion December 10, 2009 filing. SRI estimated an immediate increase to rate base from the transaction of \$37 million from these expense categories. PHG Conditions App. A. The Commission agrees with SRI that applying the pension, OPEB and other changes increases rate base. If Dominion is correct regarding the \$4 million regulatory liability, the rate base increase over and above the effect of the §338 Election is still in excess of \$30 million. This increased rate base will endure long into the future. The Commission finds that these rate base increases are solely the result of the terms of the SPA. This further buttresses the Commission's conclusion that the proposed sale would adversely impact the public in this state.

c. Consolidated Taxes

A third financial detriment alleged by the intervenors in this matter is the loss of consolidated taxes under the umbrella of the 120 companies that participate in the consolidated Dominion tax return. Rate Order at 32. The consolidated tax return allows those affiliated corporations to share losses that offset profits at other affiliates. The net effect of a consolidated return is to reduce the effective tax rate from the statutory federal income tax rate of 35% to a lesser amount. As more fully described in the recent rate proceeding, however, the effective Dominion income tax rate has trended higher in recent years. Based on recent years, the Commission trended that amount to an effective tax rate of 30%. *Id.* Thus, the Commission finds that the difference in the effective tax rate derived in the last rate proceeding and the statutory rate is relatively minor, but is another instance of adverse rate impact.

d. Bonus Depreciation

Another financial detriment raised by the intervenors in this matter is the loss of bonus depreciation that the federal government made available under the American Recovery and

Reinvestment Act of 2009 Stimulus. CAD listed this loss as a negative consequence of the sale, but did not present an estimate of the amount of lost depreciation involved. CAD Initial Brief at 17. Hope witness Taylor estimated that the total loss of bonus depreciation for Peoples would total approximately \$3.8 million, but did not have available figures for Hope. CAD Cross Ex. 28. The Commission finds that the loss of bonus depreciation from the Stimulus is a financial detriment caused by the transaction, but judging from the relative size of Hope to Peoples, the lost depreciation would not exceed \$1.25 million. The Commission finds that the loss of bonus depreciation is an adverse impact of the sale, even though this impact, standing alone, is relatively small and would not, by itself, be a substantial justification for denying the sale.

e. Financing Costs

The intervenors also argued that SRI would experience higher financing and operations costs than Hope currently incurs under Dominion. The Commission recently completed an analysis of the costs incurred by Dominion under Hope and granted a rate increase based on current costs under Dominion ownership. The Commission also noted in the Rate Case that the nation continues to experience financial tumult that makes sound prediction of future finance costs difficult.

Frankly, the Commission believes that precise estimation of any potential increase in financing costs based on the present record is speculative at this point. SRI may incur higher financing costs once it takes ownership of Hope, but the Commission is hesitant to reach a conclusion concerning this issue because of the speculative and unsettled nature of the financial markets. Those potential conditions could also affect Dominion as demonstrated by the two bond issues Dominion conducted during this proceeding including an 8.875% bond issue in December 2008 and a subsequent issue for 5.2% in August 2009. Hope Ex. 17 at 14 and CAD Cross Ex. 24. Therefore, the Commission does not find that it should reject the sale on the basis of higher finance costs.

f. Financial Conclusion

As stated above, the Commission has considered five categories of financial impacts arising from the SPA that the intervenors assert are adverse to the public in this state, some of which are relatively minor or somewhat speculative and some of which more immediate and substantial. The Commission has determined that the loss of the consolidated tax adjustment the increased financing costs and the loss of bonus depreciation are relatively small impacts that do not contribute significantly to a justification for denying the Application.

At least two categories of financial impact relating to increased rate base have a substantial bearing on Hope and therefore its customers. The §338 Election and the other rate base impacts aggregate to a total rate base increase to Hope of approximately \$60 million in the first year after the closing. That impact may subside to some degree over the foreseeable

future, but an increased cost endures from higher rate base arising from the terms of the SPA for many years into the future.

SRI has acknowledged this adverse impact in the PHG Conditions by requesting an immediate tariff rate increase of \$7.2 million, nearly doubling the increase awarded Hope in the Rate Order. PHG Conditions at pgs 12-13 and Rate Order App. B. Offsetting this impact is the \$27 million rate credit Dominion offered conditioned on a timely closing on the SPA. At the tariff rate level SRI requested, the rate credit is exhausted in approximately four years, with many years of increased rates that would exist beyond exhaustion of the credit. CAD estimates the present value of the rate impact of the terms of the SPA discussed above at \$50 million. While difficult to quantify precisely, the Commission believes that the present value of the total rate impact is well over the \$27 million rate credit offered by Dominion. In response to the CAD suggestion, however, Dominion has decried its financial position regarding Hope and spurned increasing its rate credit offer for Hope customers. In the face of the financial situation presented by SRI, and not substantially challenged, the Commission is compelled to find that the terms of the SPA have an adverse impact on the public in this state under W.Va. Code §24-2-12. The aggregate adverse impact appears to be at least the additional \$23 million estimated by the CAD, or more, above the \$27 million credit offered by Dominion. Based on this significant detrimental rate impact that is not offset by Dominion's proposed rate offset credit, the Commission cannot approve this sale.

3. Managerial Capacity

In addition to the financial concerns expressed by CAD and Staff, they also cited concerns about the managerial capacity of SRI on this record, primarily, an apparent lack of senior management to operate Hope and Peoples at closing and to procure gas after conclusion of the SPA. While SRI initially proposed outsourcing interstate gas procurement, it subsequently committed to purchasing that gas itself. December 15, 2009 SRI Response at 4. While the financial detriments discussed above are adverse to the public interest in this state, the Commission is also concerned with the managerial capacity of SRI to adequately operate Hope after the acquisition.

At hearing, CAD presented an exhibit tendered by Hope in discovery listing several gas purchasing officers and senior managers slated to remain with Dominion. CAD Cross Exhibit 21. SRI, however, did not demonstrate that it could immediately substitute new management for the employees staying with Dominion. Instead, SRI plans to rely on Dominion under the TSA for almost all management for up to eighteen months. SRI presented information showing that it owns or operates other properties including a port facility and a natural gas transportation corporation. SRI has invested in a venture that is constructing an electric transmission line in California. SRI Ex. CPK-D at 4. While these ventures may be substantial infrastructure investments, none of these properties are the equivalent of operating two large local gas distribution companies. Although SRI also touted the abilities of its chief operating officer and indicated that he would initially step into a

supervisory role at PH Gas and also may review gas procurement contracts, the Commission believes that plan is inadequate. SRI Ex. CPK-R at 29 and MJC-R at 17.

The Commission is concerned about that the lack of senior management and finds that the plans presented by SRI are inadequate. While the Commission understands and appreciates that managing a natural gas utility is a new undertaking for SRI and, thus, it may not have an existing management team, the Commission believes that SRI should have made greater effort to procure senior managers and at least presented a concrete plan for quickly filling vacant operations positions.

The list of employees that will remain with Dominion shown in CAD Cross Ex. 21 reinforces the gravity of the management openings. SRI has been aware that it would need to fill numerous vacancies since at least March 2009. The Commission acknowledges that SRI may eventually fill the vacant positions, possibly even before the end of the TSA, but the record before us fails to convince the Commission that SRI has a sufficient plan for adding management capacity to operate Hope after the TSA.

4. Adverse Impact Conclusion

For the reasons stated above, the Commission finds that the transaction presented by the Applicants in the SPA is adverse to the public interest in this state. The record unmistakably demonstrates adverse revenue requirement impacts attributable to the SPA that are not remediated by the conditional rate credit offer. In addition to the critical adverse financial impact, SRI has failed to demonstrate that it possesses now or has a definitive plan to acquire the managerial capacity to own and operate Hope after the acquisition.

E. Other Conditions

The Commission has reviewed a number of recommended conditions provided by CAD, Staff and SRI. Some of those conditions are recommended by all parties, while SRI objected to other conditions. Further, many of these conditions were offered in filings after the hearing and have not been refined, vetted or clarified by the parties through the adversarial process. The Commission does not intend to undertake to array or list these conditions in some improved or acceptable manner under those circumstances. Even if it were to attempt to do so, the Commission could not conclude, from the record, that a particular combination of conditions would offset the adverse impacts of this transaction. Given the other rulings made by the Commission, it is unnecessary to address them.

We do not believe that problems and negative impacts of SRI's acquisition of Dominion Hope are so intractable that the transaction could never meet the statutory public interest test. Given appropriate agreements, acquisition terms, commitments, and conditions imposed on Dominion and SRI, the elements that make this transaction contrary to the public interest could be rectified. This would not be an easy task, and would require cooperation and a realization that any resolution of the public impact problems must address and obviate these

problems. Unfortunately, none of the parties has given us a proposal that defined each element of the transaction that contributed to the negative public impact with reasonable specificity and then suggested an acceptable, or even possible, remedy to those problems.

We note that all parties appear to agree that there are increased rate impacts that will occur solely because of the structure of the sale. SRI has quantified the impact to be \$7.2 million, but has neither indicated to what extent that \$7.2 million may decline in subsequent years nor presented its view of the present value of the increased rate impact over the next five years, ten years, fifteen years, or more. These are important questions that go to the adequacy of any rate credit offer. Dominion has indicated that the impact may be different, but has not quantified its alternative to SRI's calculation. Dominion has offered a \$27 million cash trust that it says that the Commission may use to offset the rate increase that is caused by the structure of the sale; however, Dominion has not indicated how long the \$27 million will offset either SRI's view, or Dominion's view, of the rate increase. Neither has Dominion indicated its view of the increased rate impacts that will remain when the \$27 million is gone nor indicated how long those rate impacts will continue. The CAD has suggested that a rate credit trust of at least \$50 million is necessary, but has not provided its calculations of that number.

We understand that there probably would be differences of opinions regarding the answers to the questions posed above. Dominion may believe that the \$7.2 million is inaccurate and that a lower number is the true first-year impact of the transaction on rates. Some parties may believe that the ADIT rate base impact will disappear over 15 years, others may assume it will disappear over a shorter or longer period of time. There may be potential agreement on whether the decline in the ADIT impact will be a straight line or a curve, but nobody has addressed that. Similar issues could have been addressed regarding the loss of other rate base offsets. While there seems to be agreement that the negative impacts will be partially offset by a reduction in SRI's OPEB expenses in the amount of approximately \$2 million, no one has suggested whether the benefit of such an expense reduction is likely to remain static, or would be higher or lower if viewed over a period of years. The Commission could assume that the impacts that increase rate base would decline pro-rata over a twenty year period and calculate a present value of the rate impact as approximately \$47 million over 15 years or \$60 million over 20 years at a 3 percent discount rate. At a 6 percent rate, these values would be closer to \$41 million and \$50 million. If the Commission was to consider the adequacy of a rate credit trust fund, these issues would factor into the determination of the adequacy of such a fund, but no party has addressed the issues.

We have given all parties a clear indication of our desire for a proposal to at least provide a meaningful discussion that addresses the negative impacts of the transaction. All to no avail. Considering the complexities of this case, the odd post-hearing "filings" by the parties, and most importantly the lack of agreement between Dominion and SRI, we do not believe that it is the Commission's duty to fashion the transaction and the operational structure of SRI. We also do not believe that in a case such as this, the Commission should undertake to impose conditions. This case involves a sale of a major gas utility, a significant

transaction in another State that may or may not require a similar structure, and complex accounting and tax issues that could have different outcomes depending on the structure of the sales agreement. Under those circumstances, the development of a coherent, complete, and properly interrelated set of terms, conditions, and commitments should have at least been hammered out between Dominion and SRI.

F. Motions to Supplement Record

CAD and Dominion both filed motions to supplement the record in this matter to include copies of documents filed before the PaPUC in the parallel sale proceeding involving Peoples. No party actively opposed the motions. It is reasonable to grant both motions because the SPA provides that regulatory approval in both states is a prerequisite to a closing under the SPA. See, SPA at 45-6. The Commission will also take administrative notice of the November 19, 2009 Order of the PaPUC approving the sale of Peoples.

IV. FINDINGS OF FACT

1. Dominion, Hope and SRI filed a joint application to transfer all the common stock of Hope from Dominion to SRI. See, Application.

2. Dominion and SRI signed the SPA to govern the sale and elected to treat the stock sale as an asset sale for tax purposes. Id.

3. Dominion made a conditional rate credit offer of \$27 million that it proposed to pay into escrow for distribution to Hope ratepayers as the Commission directed. December 2, 2009 Dominion Filing.

4. SRI requested an immediate additional \$7.2 million in annual tariff rates and charges to reflect the increased rate base after the transaction. PHG Condition 39.

5. The SRI tariff rate increase request flows solely from an immediate increase in rate base of approximately \$60 million caused primarily by the structure of the SPA. PHG Conditions App. A.

6. The §338 Election will have a net increase in Hope rate base of \$23 million in the first year after closing on the SPA and will continue to increase rate base for many years following closing due solely to the terms of the SPA. Id., and CAD Ex 10.

7. The reduced offset to rate base from (i) the pension transfer, (ii) loss of prepaid OPEB ADITs and (iii) elimination of the regulatory liability increases Hope rate base by \$37 million in the first year after closing and will continue to increase rate base for many years following closing due to the terms of the SPA. PH Gas conditions Appendix A and See, December 14, 2009 CAD Response.

8. CAD estimates the total cost of the effect of the SPA on Hope ratepayers at \$50 million. December 14, 2009 CAD Responses.

9. The changes to rate base flowing from the SPA yield a total cost increase to Hope customers well in excess of the impact of the \$27 million rate credit.

10. SRI has not presented an adequate plan to replace, add or supplement management capacity responsible for Hope operations and gas procurement.

11. SRI has only presented one employee with operational knowledge of managing a retail natural gas utility. See, SRI Initial Brief at 25-30.

12. CAD and Dominion requested to supplement the record with additional information including documents from the parallel proceeding for SRI to acquire Peoples before the PaPUC.

V. CONCLUSIONS OF LAW

1. A transaction for the sale of a majority of the common stock in a public utility must have prior Commission consent and approval. The Commission may grant consent on a proper showing that (i) the terms and conditions of the transaction are reasonable, (ii) neither party to the transaction is given an undue advantage over the other and (iii) the transaction does not adversely affect the public in this state. W.Va. Code §24-2-12.

2. The Commission must also find that SRI has the knowledge, experience and resources to operate Hope. The Commission concludes that SRI has failed to make that showing. Hope Gas Inc., Case No. 99-0462-G-PC (Commission Order, July 27, 1999).

3. The adverse financial consequences of the SPA would exhaust the \$27 million conditional rate credit in approximately four years. See, PH Gas Conditions Appendix A and CAD Exhibit 10.

4. The terms of the SPA impose higher tariff rates on Hope customers well beyond the four years that the rate credit will last.

5. The terms of the SPA even with the proposed conditional rate credit yield higher tariff rates for many years following closing solely attributable to an approval of the sale.

6. Hope needs responsible senior management to properly operate the utility starting at the close of the transaction and beyond the TSA.

7. The negative financial impact and lack of managerial capacity of SRI make this sale adverse to the public interest in this state.

8. The adverse impacts of the sale are not offset by other alleged benefits set forth by SRI.

9. This sale does not satisfy the standards established in W.Va Code §24-2-12 and should be denied.

10. It is reasonable to grant the requests to supplement the record from CAD and Dominion regarding developments before the PaPUC and to take administrative notice of the November 19, 2009 order from that body.

VI. ORDER

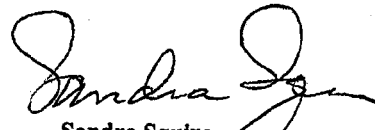
IT IS THEREFORE ORDERED that the Petition for sale of Hope to PH Gas as described by the SPA is denied.

IT IS FURTHER ORDERED that the motions to supplement the record from CAD and Dominion are granted and the Commission also takes administrative notice of the November 19, 2009 Order from the PaPUC.

IT IS FURTHER ORDERED that on entry of this Order, this matter shall be removed from the active docket of Commission cases.

IT IS FURTHER ORDERED that the Executive Secretary shall serve a copy of this Order on all parties to this proceeding by United States Mail and on Staff by hand delivery.

A True Copy, Teste:


Sandra Squire
Executive Secretary

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STATE OF CONNECTICUT

PUBLIC UTILITIES REGULATORY AUTHORITY
TEN FRANKLIN SQUARE
NEW BRITAIN, CT 06051

DOCKET NO. 13-06-08 APPLICATION OF CONNECTICUT NATURAL GAS
CORPORATION TO INCREASE ITS RATES AND
CHARGES

January 22, 2014

By the following Commissioners:

Michael A. Caron
Arthur H. House
John W. Betkoski, III

Lead Staff: Donna M. Devino
Legal Advisor: Robert E. Luysterborghs

DECISION

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DECISION

I. INTRODUCTION

A. SUMMARY

In this Decision, the Public Utilities Regulatory Authority reviews the Connecticut Natural Gas Corporation's request for a rate increase. It requested an increase in revenue of \$20.047 million and a 10.25% return on equity. The Public Utilities Regulatory Authority approves an increase in revenue of \$6.505 million and a return on equity of 9.18%. Also approved were mechanisms for tracking and reporting pipeline system expansion costs and revenues, earning sharing, decoupling and implementing a new federal gas pipeline integrity management program.

The earning sharing mechanism encourages the earning of revenues above the allowed return on equity. The mechanism provides for a 50/50 sharing of the additional revenues with customers whenever the collected revenues result in earnings above the approved return on equity.

The decoupling mechanism permits the collection of revenues necessary to maintain and operate the distribution system. The revenues collected for gas sales will be credited back to customers.

With regard to needed pipeline repair and replacement, the Public Utilities Regulatory Authority approves a Distribution Integrity Management Program mechanism that allows recovery of the revenue requirement for main replacement activity between rate applications. Additionally, the Public Utilities Regulatory Authority approves a schedule and budget for system integrity projects that target needed replacement of cast iron mains, bare steel mains and bare steel services.

Regarding system pipeline expansion improvements, the Public Utilities Regulatory Authority directs the Connecticut Natural Gas Corporation to track and report its actual revenue requirement and revenues for the gas pipeline expansion activities through a System Expansion Reconciliation Mechanism.

The Public Utilities Regulatory Authority finds that the approved increase in revenues, the return on equity and the rate mechanisms described above, along with other determinations made in this Decision, will result in just and reasonable rates, and will provide the Connecticut Natural Gas Corporation with sufficient revenue to maintain and operate a gas distribution system and provide a safe, adequate and reliable service to customers, while providing it an opportunity to earn a reasonable profit.

B. BACKGROUND OF PROCEEDING

By application dated July 8, 2013, the Connecticut Natural Gas Corporation (CNG or Company) filed an application (Application) with the Public Utilities Regulatory Authority (Authority or PURA) to amend its existing rate schedules. CNG seeks annual base delivery rate revenues of \$357 million, which represents an increase of approximately 6.3% over the total revenues that would be expected under current rate schedules and projected sales on a total bill basis. In the Notice of Intent dated June 7,

2013, CNG communicated that its need for additional revenues is to ensure that it has sufficient financial strength and resources to continue to invest in critical energy infrastructure to support the goals of the State of Connecticut's Comprehensive Energy Strategy (CES) and to continue to meet CNG's public service obligation.

C. CONDUCT OF PROCEEDING

By Notice of Audit dated September 3, 2013 and October 3, 2013, the Authority conducted an audit of the books and records of the Connecticut Natural Gas Company on September 4, 2013 and October 8, 2013, at the offices of the Company, UIL Holdings Corporation, 157 Church Street – Conference Room 1609, New Haven, CT.

By Notice of Hearing dated September 11, 2013, and Notice of Postponed Hearing dated September 20, 2013, pursuant to §§16-11, 16-19, 16-19b, 16-19e and 16-19kk of the General Statutes of Connecticut (Conn. Gen. Stat.), and §16a-35-49 of the Regulations of Connecticut State Agencies (Conn. Agencies Regs.), the Authority held a public hearing on this matter on September 24, 2013, at its offices, Ten Franklin Square, New Britain, CT. The hearing continued at the offices of the Authority on September 25, 26, and 27, 2013, and October 15, 16, 17, 18, 22, 23, 24 and 25, 2013. A Hearing, for public comment only, was also held on September 24, 2013, at 6:00 p.m., at the offices of the Authority, Ten Franklin Square, New Britain, CT.

D. PARTIES AND INTERVENORS

The Authority recognized the following as Parties to this proceeding: Connecticut Natural Gas Corporation, P.O. Box 1500, Hartford, CT 06144-1500; The United Illuminating Company, P.O. Box 1564, New Haven, CT 06506-0901; Office of Consumer Counsel, Ten Franklin Square, New Britain, CT 06051; and Department of Energy and Environmental Protection, 79 Elm Street, Hartford, CT 06106. The Authority granted Intervenor status to the following: Office of the Attorney General and the CT Independent Utility Workers Local 12924.

E. PUBLIC COMMENT

The Authority conducted an evening hearing for the purpose of receiving comments from the general public concerning CNG's Application. The Company's August 13, 2013 notice to customers regarding the hearing, was approved by the Authority on August 16, 2013. The evening public hearing was conducted at the offices of the Authority on September 24, 2013, and no members of the general public submitted testimony.

The Authority received approximately 70 letters and emails from customers regarding the Application. The correspondence received by the Authority was unanimous in its opposition to the rate increase proposed and indicated that CNG's request was excessive and not in line with current economic conditions. Customers also noted that CNG's request would have a very negative effect on families or those on fixed incomes, such as senior citizens. Further, customers questioned why CNG would seek such a large rate increase when there was a drop in the commodity price of natural gas due to an increased availability of the resource.

II. AUTHORITY ANALYSIS**A. TEST YEAR / RATE YEAR**

It is the practice of the Authority in utility rate cases, to establish rates prospectively on the basis of historical test year, adjusted for pro forma purposes. In this case, CNG determined that the test year is the 12-month period ended December 31, 2012. The rate year is the 12-month period ended December 31, 2014. Earley PFT, p. 2.

B. RATE BASE**1. Capital Expenditures by Major Class**

The table below shows CNG's proposed capital expenditures by categories for the rate year 2014 and it illustrates an increase/decrease as compared to the test year capital expenditure.

Project	Proposed Calendar Year 2014 Expenditure (\$000's)	Test Year Expenditure (\$000's)	Increase/Decrease (\$000's)	Percentage Increase for Non-One Time Projects (%)
Information Technology (IT)	\$31	\$386	-\$355	-1,455%
IT (GIS/Mobility/WMS)	\$2,478		\$2,478	NA
Storage Plant	\$178	\$145	\$33	23%
Storage Plant (LNG Modernization)	\$3,248		\$3,248	NA
Storage Plant SCADA	\$3,530		\$3,530	NA
New Business	\$21,095	\$11,870	\$9,23	78%
Cast Iron Planned	\$12,600	\$11,495	\$1,105	10%
Cast Iron Accelerated	\$2,867		\$2,867	NA
Other replacements Reliability	\$1,840	\$1,866	-\$26	- 1%
Meters Regulator Installations	\$5,662	\$5,293	\$369	7%
District Regulators	\$372	\$582	-\$210	-4%
Power operated Equipment	\$850	\$694	-\$156	-22%
Other Equipment	\$10		\$10	NA
Tools Shop and Garage	\$209	\$121	\$88	73%
Land Structures Improvements General	\$2,495	\$185	\$2,310	NA
Total	\$57,465	\$32,637	\$15,291	76%

Reis, McNally and Jalette PFT, p. 13.

The table above shows a total of \$15.29 million increase in capital expenditures between the test year and calendar year 2014. This represents a 76% increase in spending.

The New Business, Cast Iron Planned and Cast Iron Accelerated projects represent 63.6% of the proposed capital expenditure. Specifically, New Business

Decision and impact the cash working capital the Company needs. The Authority also made other adjustments to the expense and income levels used by CNG to calculate its cash working capital request so that the end result is based on expense and income levels that mirror the expense and income levels allowed by this Decision.

f. Conclusion on Working Capital

Based on the adjustments detailed above related to cash working capital, the Authority calculates a cash working capital requirement for the Company of \$14.189 million. This amount is \$10.248 million less than the \$24.437 million proposed by the Company. As such, the Authority allows a cash working capital of \$14.189 million (\$24.437 - \$10.248 = \$14.189).

5. Accumulated Deferred Income Taxes

This rate case provides the first review for the Authority, from a ratemaking perspective, of UIL Holdings Corporation's (UIL) acquisition of CNG from Iberdrola, USA. The change of control was approved by the Decision dated November 10, 2010 in Docket No. 10-07-09, Joint Application of UIL Holding Corporation and Iberdrola USA Inc. for Approval of a Change of Control of Connecticut Natural Gas Corporation and the Southern Connecticut Gas Company (Change in Control Decision). In that Decision the PURA "formerly the Department" stated the following with respect to the ratemaking treatment associated with the method under which the change of control was accounted for and its impact on Accumulated Deferred Income Taxes (ADIT):

In the instant Decision, the Department is not approving any accounting treatment. Therefore, there is nothing compelling or limiting the Department, in future rate proceedings, from considering the rate impact of any legal tax law election. In such future rate proceedings, all parties will have the opportunity to review and determine the propriety of UIL's assertion that the elimination of the ADIT from CNG's and Southern's regulatory books of account will, in the end, result in rate base changes. The Department is keenly aware of the potential tax normalization issue that will surface in any rate case subsequent to the Closing. The Department's position is that the change of control should not impact the cost of utility services that are provided to ratepayers. In subsequent rate case proceedings, CNG and Southern would be required to show that all accounting treatments resulting from the Proposed Transaction will not have adverse impacts on rates. Also, CNG and Southern will be required to file all journal entries to record the eliminations of the ADIT existing prior to the Closing. Furthermore, UIL will be directed to file exhibits, separately for CNG and Southern, showing the total book basis, total tax basis, total accumulated book depreciation and total accumulated tax depreciation for utility plant assets as of the period immediately prior to the Closing. UIL is hereby put on notice that, while the Department is allowing the 338(h)(10) Election, it is not recommending or by any stretch requiring such an election. UIL proceeds at its own risk regarding the ratemaking treatment that may or may not be afforded any election. The Department intends to safeguard ratepayers from adverse impacts due the change of control.

Change in Control Decision, pp. 23 and 24.

There was significant discussion, with diverging viewpoints, regarding the ADIT issue during the proceeding. At question is an ADIT balance that at the time of the change in control was a credit balance of \$78.3 million. Due to the change in control being accounted for using a 338(h)(10) election, UIL restated its rate base at book value for ratemaking purposes and as a result extinguished its ADIT balance. There are ratemaking implications, as ADIT credit balances are an offset to rate base. The Parties agree that the remaining amount of unamortized ADIT in question, due to amortization since the change in control, is approximately a credit balance of \$62,807,000 as of October 2013 and a credit balance of \$60,272,000 as average rate base for 2014. Late Filed Exhibit No. 51; Tr. 11/5/13, pp. 2253 and 2254.

Two main arguments were presented regarding the ADIT issue, the treatment that should be afforded the ADIT from a transactional view and in keeping with IRS regulations. The Company stated that the acquisition transaction must be viewed in totality. The transaction benefitted CNG, the Company's customers and the State in a variety of ways (e.g., commitment to infrastructure, natural gas growth, job creation, as well as energy efficiency). Moreover, the 338(h)(10) Election is just one of many components of this proceeding and it should not be singled out. The Company contended that ADITs are properly extinguished, due to the benefits of the change in control. The Company also stated that any "hold harmless" adjustment in connection with the 338(h)(10) Election are not warranted and could lead to severe adverse consequences for CNG and its customers. The implementation of a "hold harmless" adjustment would constitute a tax normalization violation that would prohibit CNG from claiming accelerated depreciation going forward – thereby causing the Company to lose a cost-free source of financing with customers losing a future rate base offset. CNG Brief, p. 4.

The OCC contended that while CNG relied on the discussion in the Change in Control Decision, the Company failed to provide information in its Application or in responses to interrogatories that would allow the Authority, the OCC or other docket participants to ascertain any financial benefit to ratepayers. It only argued about the detriment of the removal of the ADIT credit. Employee counts have increased, rather than decreased, and corporate costs have drastically increased. Corporate charges have increased from \$18.803 million in the test year to \$22.841 million in the rate year. The amount was subsequently updated to \$23.819 million and is a substantial increase compared to the rate year amount authorized in the prior rate case of \$8,932,293 for affiliate charges, which was prior to the change in control. In addition, when asked during the hearing, "[i]s there anything you can point to that you presented in this case that would show the Authority which direction the revenue requirements have gone pre change in control versus post," the Company responded by saying "it's very difficult to look pre change of control versus post because of all the things that have changed." OCC Brief, pp. 130 and 131.

The OCC recommended a "hold harmless" adjustment be made associated with the change in control approved in the Change in Control Decision. This recommendation is for the purpose of protecting ratepayers from the negative financial and rate consequences that result from that transaction, consistent with the Authority's intent to safeguard ratepayers from adverse impacts due to the change of control in that proceeding. Under the Section 338(h)(10) election, the acquiring entity is allowed to step up its basis of the acquired assets but as a consequence, the accumulated

deferred tax balance existing before the change in control is eliminated, (i.e., the deferred tax liability becomes a current tax). Id., pp. 125 and 126.

The OCC disagreed with the Company's position that a potential normalization violation would occur if a "hold harmless" adjustment is reflected in CNG's revenue requirements that result from the current proceeding. The recognition of a rate base credit equal to the pre-acquisition ADIT balance as recommended has been utilized in other State jurisdictions. The OCC contended that the Company witnesses have provided no instances where a utility company has been placed on notice of a normalization violation due to a "hold harmless" adjustment being utilized in a utility rate proceeding after a Section 338(h)(10) election was made. In fact, in the 2nd Supplement to the Response to Interrogatory AC-24, in the December 31, 2012 Form 10-K, outside auditors for UNITIL, the parent company for Northern Utilities, did not find that UNITIL was in an uncertain tax position after a "hold harmless" adjustment in the form of a rate base credit associated with pre-acquisition ADIT balances were reflected in the company's rate case decided earlier in 2012. The OCC claimed that if UNITIL's outside auditors thought there was uncertainty regarding a potential normalization violation after the ratemaking adjustment was reflected in Northern Utilities New Hampshire rate case, Docket DG-11-069, they would have had to make such a disclosure in the notes to the financial statements in this SEC filing. The hold harmless adjustment could be structured in a number of ways. It could be an adjustment that reduces rate base, it could be in the form of a merger adjustment that reduces Operating and Maintenance (O&M) expenses, or could be in the form of revenue credits which are used to offset the Company's revenue requirement. Id., pp. 132 and 133.

The Attorney General (AG) argued that UIL's Section 338(h)(10) election eliminated the ADIT account, which may have benefitted the transacting companies but will harm ratepayers unless corrected by the Authority because ratepayers would no longer receive the financial benefits that the ADIT provide. The AG fully supports the OCC's proposal to structure a "hold harmless" adjustment to the CNG rate base or to devise revenue credits that would offset the loss of the ADIT. AG Brief, pp. 14 and 15.

In response, the Company stated that the OCC's proposal has no merit or foundation. It fails to recognize the (i) significant benefits that customers and the state have realized as a result of the acquisition of CNG by UIL and (ii) severe negative consequences that would result from a violation of tax normalization rules – the loss of the use of accelerated depreciation that would result from the implementation of a "hold harmless" adjustment. The Company strenuously opposed such an adjustment. It is not warranted and, if implemented, would create a problem that would dwarf the situation that the OCC erroneously contended needs to be addressed. UIL Reply Brief, p. 5.

CNG agreed that the OCC limits its perspective and analysis to selective financial aspects of the transaction and comparing costs for the rate year (2014) to those established in CNG's last rate case that was decided in 2009, well prior to the change in control. The OCC cited to two items, stating that each has increased: employee counts and corporate charges. As noted at the hearings, staffing levels that permit the Company to fulfill its public service obligations are not only reasonable but also absolutely necessary. According to Company Witness Nicholas: "We started adding jobs before the CES was even in draft form. . . . we knew we needed to beef up

staff in certain areas, and we took those steps. We didn't immediately come in and file a rate case to cover those. In addition, the employee complement requested in this case is fully supported." Id., p. 6.

With respect to Corporate Charges, the Company claimed that they form a part of the costs required to fulfill public service obligations. For example, upgrades to computer systems were an absolute necessity. Corporate charges are also properly allocated to CNG. Comparisons to corporate charges prior to the change in control are meaningless. Iberdrola USA Inc.'s (Iberdrola) shared services model was vastly different from UIL's. For example, individuals who provided local financial and regulatory support were formerly part of CNG whereas they are now part of UIL shared services (with costs then allocated). As stated by Mr. Nicholas, "it's a very natural reaction, show me the dollars, but, you know, we've got apples and bananas and oranges and whatever fruit you happen to choose." The relationship of CNG to UIL versus CNG to Iberdrola is very different. Aside from "alignment" factors, it is pointless to compare Iberdrola shared services costs from several years ago to UIL shared services costs today – given underlying inflation and cost increases due to the passage of time. Id., pp. 6 and 7.

In addition, CNG posits that customers have benefitted from the Company's ability to manage its operations and not initiate a rate case for almost three years since the change in control. This occurred even in the face of the significant expenditures that were necessary to make such as investment in connection with new business growth, increasing employee count to address public service obligation needs, and implementing a much needed customer information system. The Company maintains that the Change in Control Decision could have been adjudicated through a settlement agreement that incorporated a "stay out" provision. However, even without such a settlement, the Company has, "stayed out" with rates remaining the same for quite some time following the acquisition. Id., pp. 7 and 8.

According to the Company, the task for the Authority is to arrive at just and reasonable rates. As was discussed in the Change in Control Decision, the entirety of the transaction must be taken into account when examining the ADIT balance under discussion *and* that the ADIT balance must be reviewed against the backdrop of the entire rate request that is under review. The OCC isolated a single feature of a very large and complex transaction rather than evaluating the transaction as a whole. Every transaction has costs and the ADIT extinguishment was a cost of the transaction. The OCC inappropriately takes this single, particular issue and seeks a "one-for-one" adjustment. Id., p. 8.

In terms of a normalization violation, CNG suggested that the OCC's characterization of the Company's position is inaccurate. The OCC stated that "[i]t appears that the Company is concerned that implementing a hold harmless adjustment based on an evaluation of the revenue requirement impact of the eliminated ADIT balance could violate the IRS's normalization rules." OCC Brief, p. 131. The Company (through its tax expert, Mr. Warren) stated that such an adjustment would constitute a normalization violation which would preclude the Company from claiming accelerated depreciation going forward. Moreover, as stated by Mr. Nicholas, "... there's no way I would sign a return to the IRS if we knowingly had violated the normalization rules. ... Thus, if the Company considered that an order issued by the Authority constituted a

violation of the normalization rules, the imposition of the penalty would be self-executing. The Company would be compelled to file its subsequent tax returns without claiming accelerated depreciation." Id., pp. 8 and 9.

The Company addressed the tax issues emanating from the 338(h)(10) Election, including the normalization consequences of a "hold harmless" adjustment. While the OCC opined that a "hold harmless" adjustment would not violate the normalization rules, the Company stated that its sole support for this assertion consisted of two regulatory orders. In each of these orders, regulators approved settlements relating to acquisitions in which 338(h)(10) elections were made. In these settlements, the purchaser agreed to implement a "hold harmless" adjustment. The Company asserted that the OCC failed to acknowledge the true revenue requirement associated with the ADIT balance that was extinguished as a result of the 338(h)(10) Election. These were calculated by the Company and provided in Late Filed Exhibit No. 51 Supplemental. CNG determined a revenue requirement impact for the rate year of \$3.8 million (as opposed to the \$11.9 million claimed by the OCC).

As previously mentioned, there are two main arguments presented regarding the ADIT issue, the treatment that should be afforded the ADIT from a transactional view and in keeping with Internal Revenue Service (IRS) regulations. The Authority will first address the totality of the transaction.

The Company was requested, in Interrogatories OCC-174 and OCC-409, to provide analysis of how the change in control with its 338(h)(10) election did not have an adverse impact on rates. The Company's responses provided issues being addressed by CNG that would not have been addressed under other ownership. While the Authority is aware that "what if" analyses can be difficult to perform, the Company provided qualitative evidence regarding the impact of the change in control and 338(h)(10) election when justifying its totality of transaction argument. It has been in excess of four years since the Change in Control Decision was finalized. The Company had ample opportunity to formulate a process by which to legitimize its argument of ratepayer benefit through the transaction by means other than qualitative arguments. Additionally, in the Change in Control Decision, the Authority stated that:

Any rate proceeding will be based on a complete and full analysis of the operating company seeking the rate change, including its expenses, revenues, management prudence, customer service, no less, and guided by Conn. Gen. Stat. §16-19e. When that happens, only then will rates change, up or down, as appropriate.

Change of Control Decision, p. 8.

The instant proceeding is the very rate proceeding that the Authority contemplated with the above statement in the Change of Control Decision. Discovery has taken place and the Company had the chance to state its case regarding impacts of the 338(h)(10) election and rate impacts. The Authority reviewed the Company's positions that it used in its totality of transaction arguments. One argument the Company makes is that it is investing in replacing aging infrastructure over and above what had been done under prior ownership. This appears to be more of a local distribution company (LDC) norm of accelerating this infrastructure replacement than a conscious infrastructure decision by CNG. In its last rate case, Yankee was ordered to

accelerate its replacement program. 2010 Yankee Gas Decision. Combined with changes in Federal regulations, this appears to be something that would have taken place with or without the change of control. In fact, in the same testimony, the Company witness acknowledges a cost with this increased replacement.

The Company seems to infer that ownership under Iberdrola would have deteriorated to a point of not meeting public service obligations. This is an extreme assumption. The same can be said of the new customer information and billing system. The Company stated that one reason that corporate costs are higher is because they have implemented new customer information and billing systems. The Company goes on to say that, in fact, Iberdrola had a plan to replace them at some point and likely would have been done under their ownership. Tr. 10/16/13, p. 910. Again, it appears that the customer information and billing systems would have been undertaken regardless of the change in control. In the same testimony the witness finishes this thought by stating, "... so I think you have to look at, you know, are ratepayers in a good position under UIL's ownership in, total, and I think the answer is an unresounding yes, as compared to what was happening under its prior ownership." Tr. 10/16/19, pp. 910 and 911. The conclusions drawn by the Company, with these items, are questionable at best.

The Company also made claims of adding jobs in Connecticut for various programs, including the CES. However, when asked if the creation of these jobs would have happened absent the change in control, the Company was unable to provide a response. The Company stated "[t]here would have been something. Would it be the same? I don't know." *Id.*, pp. 911 and 912.

Regarding the CES involvement, the Authority finds that the Company's claim unfounded that its involvement was "crucial" and warrants some benefit in terms of viewing the totality of the transaction. The CES is the single largest piece of energy legislation in Connecticut with regard to natural gas LDCs. While CNG may have played an important role in its development, to think that anyone operating an LDC in Connecticut, let alone two LDCs, would not have had a significant involvement in crafting such energy policy is doubtful at best.

The Company's argument that it has not filed for a rate increase since the change in control is also unsubstantiated as a perceived benefit resulting from the transaction. As admitted by the Company witness, there is no way to tell if the former owners of CNG would have filed any sooner, or therefore later, than what CNG has done under its ownership. As UIL and Iberdrola are both for profit entities, and lacking any evidence to the contrary, no assumption can be made that the filing of a rate case would have been different, under either entities ownership.

The Authority finds a lack of evidence regarding CNG's claim that customers are in a better place now than prior to the change in control. Based on the evidence that the Company provided, there is no indication that the transaction has provided accrued benefits to ratepayers that would not have occurred absent the change in control. Evidence presented on normalization violations and 338(h)(10) elections was provided by the Company and the OCC. This included actions taken by other public utility commissions (PUCs), Federal Energy Regulatory Commission (FERC), private letter rulings (PLR) answered by the IRS and individual party testimony supporting very

different views on the issue. The Company provided examples that it contended supported its position. This included ten attachments, consisting of two FERC decisions, four FERC letters and four IRS PLRs. Late Filed Exhibit No. 52.

The OCC provided examples that it believed supported its position. These consisted of three decisions of PUCs that were the result of settlements. Response to Interrogatory AC-24. The OCC supplemented the response to Interrogatory AC-24 to include excerpts from Northern Utilities, Inc., a Company which was the subject of the three PUC decisions provided by the OCC.

The Authority will first review the examples provided by the Company. Attachments 7 through 10 of Late Filed Exhibit No. 52 are PLRs answered by the IRS. All four PLRs have their own set of circumstances. However, the relevant question for this proceeding being answered by the IRS of ADIT balances and normalization requirements regarding Section 338(h)(10) election are common for these PLRs. The PLRs provided all include similar language with respect to ADITs, Section 338(h)(10) Elections and Normalization Rules.

This election results, for federal income tax purposes, in a deemed taxable sale of assets by Target (as old Target) to itself (as new Target) in a taxable transaction. Because of this sale, old Target's deferred tax reserve relating to accelerated depreciation is reduced under Section 1.167(l)-1(h)(2)(i) of the regulations to reflect the retirements of old Target's assets. After the application of Section 1.167(l)-1(h)(2)(i), old Target's deferred tax reserve resulting from accelerated depreciation ceases to exist. Accordingly, the deferred tax reserve resulting from accelerated depreciation should be removed from old Target's regulated books of account and not flowed through to the customers of new Target, or Taxpayer.

. . . the accelerated depreciation deduction attributable to old target's (Target) public utility property does not carryover to new target (Subsidiary). The ADFIT related to that property do not follow the assets.

Consequently, the accelerated depreciation deduction attributable to old target's (Target) public utility property does not carryover to new target (Subsidiary). Neither accumulated deferred income tax nor the excess deferred reserve related to the property follow the assets. Retirements of public utility property subject to the normalization requirements of Section 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see Section 1.167(l)-1(h)(2)(i) and Rev. Proc. 88-12, 1988-1 C.B. 637, at 639). As a result of the sale, the reserves cease to exist. A violation of the normalization rules will occur if there is any reduction to Subsidiary rate base, after the Acquisition date, for the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property.

Late Filed Exhibit No. 52, Attachments 7-10.

The PLR provided in Attachment 7 included an additional request by the taxpayer for determination if normalization rules are violated if, a taxpayer who has participated in

a Section 338(h)(10) election does not participate in a rate proceeding following the recognition of elimination of ADIT. On the issue of rate case timing, the IRS stated:

In essence, Taxpayer has requested that the Service rule that the normalization rules do not require Taxpayer to initiate a rate proceeding recognizing the elimination of the ADFIT and ADITC balances. Based on the facts of this case, the normalization rules are not violated by the Taxpayer's decision not to seek a new rate determination. The Service does not generally determine such purely regulatory questions as to when rate proceedings are required or whether the determinations of a public utility commission will produce just and equitable rates.

Late Filed Exhibit No. 52, Attachment 7.

In response to the IRS' role in ratemaking, Company witness Warren stated the following:

The service's interest is in protecting the tax benefits of, in this case, accelerated depreciation from regulatory treatment that doesn't comport with the normalization rules. They -- that's end all they're concerned with...they don't control rate-setting. They don't want to control rate setting and legally they can't control rate setting. The only thing they can do is withdraw a tax benefit that is provided by the Internal Revenue. That's the only thing they can do. So what they -- their withdrawal of that benefit will be -- may be a consequence, and in fact, it certainly will be a consequence of regulatory treatment, but they can't mandate a particular regulatory treatment. All they can do is withdraw the tax benefit if the regulatory treatment is not consistent with the normalization rules.

Tr. 11/6/13, p. 2504.

This draws the question of a regulators ability to provide a regulatory treatment when a Section 338(h)(10) election is made. As stated earlier, there are ratemaking implications associated with the 338(h)(10) election as well as a review of the totality of transaction in this docket. Is a regulator precluded from directing the utility to reflect a treatment that recognizes a difference in value that results from the election compared to proven benefits that the transaction has provided to ratepayers? Is the normalization requirement simply a mechanical exercise of removing ADIT from a Utility's regulated books with no regard to the cost of service? In the above instance, because the IRS does not require a rate proceeding within any specified time period following a 338(h)(10) election, a utility can legally provide, in continuing to apply pre-merger rates, the benefits of accelerated depreciation. This appears to draw a distinction between the accounting and ratemaking treatments that can be afforded ADITs. From evidence presented in this proceeding, it does not appear to the Authority that the specific question of regulator actions causing normalization violations has ever been addressed by the IRS.

Attachments 1 and 2 are FERC Orders. Attachment 2 refers to a February 1, 1996 decision involving Koch Gateway (Koch Order). The Koch Order resulted in a settlement, including treatment of ADIT within the context of a 338(h)(10) election.

Koch received a private letter ruling from the IRS and based on this letter ruling FERC eliminated some portion of the ADIT balance for ratemaking purposes. FERC stated that while it is not bound to follow an IRS ruling for ratemaking purposes, it was reluctant to take action which would endanger a pipeline's right to favorable tax treatment from the IRS. Late Filed Exhibit No. 52, Attachment 2, p. 18. The settlement also alludes to the settlement cost of service which includes the amortization of excess ADIT of \$10.2 million. In reference to this amortization, the decision reads:

Koch Gateway stated that this shall not preclude its right to use an accelerated tax depreciation provisions for federal income tax purposes. If the IRS proposes to preclude or limit Koch's right to use an accelerated depreciation method as a result of the procedures adopted here, Koch Gateway reserves the right to file for appropriate adjustments in its rates

Late Filed Exhibit No. 52, Attachment 2, p. 3, Footnote 8.

To the Authority, it is apparent that some portion of ADIT was reflected in rates after the PLR was received from the IRS, which prompted Koch to provide the clarification noted above. When asked to clarify the language in Footnote 8 as it related to rate setting, CNG responded that it did not know for sure and that it was not aware of what the mechanics were precisely. Tr. 11/5/13, pp. 2525 and 2526.

Attachment 1 refers to a March 19, 2003 FERC Order regarding Enbridge Pipelines (referred to as KPC). The relevant portions of this Order essentially provide the mechanical steps that are taken post 338(h)(10) election with regards to ADIT. In the Order FERC stated:

. . . because a taxable event had occurred, it had been reported to the Internal Revenue Service, taxes were due and payable on the sale, and the ADIT balances were extinguished.

Late Filed Exhibit No. 52, Attachment 1, paragraph 45.

When the taxes are due and payable on a sale, the ADIT balances are reduced to zero because of the operation of the tax laws and regulations.

Late Filed Exhibit No. 52, Attachment 1, paragraph 68.

The Company and the OCC agreed to the mechanics of the 338(h)(10) and accounting for the ADIT. Tr. 10/16/13, pp. 865 and 904. Again, the difference of opinion falls with the ratemaking associated with loss of ADIT. The Company argued that no adjustment is warranted while the OCC proposed a liability be established for ratemaking to safeguard ratepayers from the impact due to the change in control. Response to Interrogatory AC-25.

Attachments 3 through 7 to Late Filed Exhibit No. 52 consist of letters issued by the FERC in response to parties seeking clarification of accounting treatment for transactions involving 338(h)(10) elections. These letters essentially rely on previous rulings in FERC decisions; therefore, the Authority relies on the decisions themselves rather than letters that reference such decisions.

The Company testified that the ADIT treatment is always an issue in 338(h)(10) transactions and in asset acquisitions because both involve preexisting deferred taxes. Witness Warren also testified to the conventional sequence of events where parties talk through the pluses and minuses of a transaction and there is a settlement that sometimes incorporates a rate credit or some other unallocated, non-specific response to not only the ADIT issue, but everything else in the case. Tr. 10/16/13, pp. 923 and 924.

The OCC's evidence consisted of settlements approved by other PUCs. Response to Interrogatory AC-24. Settlements are not precedent setting and typically provide very few details. Therefore, the Authority can gain little evidence from these documents in terms of the vetting that occurred on the normalization issue. They do however, provide the Authority with evidence that consideration has been given to the ratemaking impacts of 338(h)(10) elections. Additionally, the UNITIL annual report is not definitive evidence that a normalization violation would not be found to have occurred in the future. The Company makes valid arguments for not relying on this document in that (1) the subject company and/or its outside auditors actually identified the normalization issue, and (2) assuming that they did, that they properly analyzed that issue. CNG Brief, p. 10.

The subject being contested here has very little history. The Company's witness has been involved in four or five instances, all of which have been settled. Tr. 10/16/13, p. 926. In instances where a specific hold harmless provision was voluntarily instituted by a utility, witness Warren dismisses this as the parties involved having no idea what they were doing. *Id.*, p. 930. Additionally, neither the OCC, the Company nor its expert witness could provide any instance where a normalization violation had occurred for any taxpayer.

The issue of normalization violations being committed as it relates to the actions of a PUC is anything but clear. The Authority will proceed with caution on this issue as the consequences of a normalization violation are severe. CNG is rightfully concerned regarding potential negative consequences of a normalization violation and stated that "if the Company considered that an order issued by the Authority constituted a violation of the normalization rules, the imposition of the penalty would be self-executing. The Company would be compelled to file its subsequent tax returns without claiming accelerated depreciation." CNG Brief, pp. 8 and 9. However, the Authority also finds that the evidence and testimony presented in this proceeding is unconvincing in terms of the creation of a normalization violation. The Authority concludes that the only means to a definitive answer on this issue is to go to the source, the IRS. The Authority hereby orders the Company to seek a private letter ruling with regards to the specific question of after extinguishment of an ADIT balance, whether or not a PUC directive to institute a ratemaking mechanism to reflect a credit to ratepayers of ADIT benefits lost through a 338(h)(10) election would constitute a normalization violation. The Company shall file its proposed draft PLR to the PURA, for approval, no later than March 14, 2014.

For the current proceeding, the Company is allowed to reflect the extinguishment of ADITs associated with the change of control. However, the Company shall, until further notice from the Authority, track the revenue requirements associated with the credit ADIT balance of \$60,272,000 as average rate base for 2014. In the event of a

ruling from the IRS stating that imposing a ratemaking mechanism would not create a normalization violation, the Authority will use this calculation as the basis for a correction of rates.

The Company stated that the cost of requesting the PLR is approximately \$70,000 and requests that it be permitted to establish a regulatory asset to defer the actual expense associated with the PLR. CNG Written Exceptions, p. 9.

The Authority denies this request as the Company itself chose to conduct the change of control by means of a 338(h)(10) election, which has led to the need for a PLR. This decision lies directly with UIL Management and therefore shall not be charged to ratepayers.

6. Table I

Table I details the Company's pro forma amounts, the Authority's adjustments and the final amounts as adjusted by the PURA. In addition to the adjustments described above, the Authority has also adjusted rate base for accumulated depreciation (-\$1.96 million) and deferred taxes (\$800,000) resulting from an adjustment to depreciation expense (see Section II.C.6. Depreciation). Also adjusted is capitalized payroll (\$92,500) and payroll taxes (\$7,000) resulting from adjustments to payroll and payroll tax expenses (see Section II.C.1 Payroll). Finally, an adjustment to deferrals in rate base resulting from an adjustment to the amortization to deferrals (\$55,000) resulting in an adjustment to amortization of deferrals (see Section II.C.12. Amortization of Deferrals).

**STATE OF CONNECTICUT
PUBLIC UTILITIES REGULATORY AUTHORITY**

JOINT APPLICATION OF IBERDROLA, S.A.,	:	Docket No. 15-07-38
IBERDROLA USA, INC., IBERDROLA USA	:	
NETWORKS, INC., GREEN MERGER SUB, INC.	:	
AND UIL HOLDINGS CORPORATION FOR	:	September 18, 2015
APPROVAL OF A CHANGE OF CONTROL	:	

SETTLEMENT AGREEMENT

WHEREAS, this Settlement Agreement is entered into by and between Iberdrola USA Networks, Inc. ("Networks"), Iberdrola USA, Inc. ("IUSA"), Iberdrola, S.A. ("Iberdrola" and collectively with Networks and IUSA, the "IUSA Affiliates"), Green Merger Sub, Inc. ("Merger Sub") and UIL Holdings Corporation ("UIL" and collectively with the IUSA Affiliates and Merger Sub, the "Applicants") and Elin Swanson Katz, Consumer Counsel, on behalf of the State of Connecticut, Office of Consumer Counsel ("OCC" and collectively with the Applicants the "Settling Parties"), in connection with the application filed by the Applicants on July 31, 2015 ("Application") for approval of a transaction that, if approved, would result in a change in control of UIL ("Proposed Transaction") pending before the Public Utilities Regulatory Authority ("Authority") in the above-referenced docket;

WHEREAS, the Applicants filed their Application for approval of the Proposed Transaction with the Authority, and the Settling Parties subsequently have engaged in discovery, hearings and negotiations concerning the Application, the Proposed Transaction and the matters addressed in this Settlement Agreement;

WHEREAS, the Settling Parties have discussed various matters related to the Application and Proposed Transaction, and wish to resolve those issues on mutually agreeable terms, and without establishing any precedent or principles applicable to any other proceedings; and

WHEREAS, it is the policy of the Authority, consistent with Conn. Gen. Stat. §16-19jj, to encourage the use of settlements to resolve contested cases and proceedings.

NOW THEREFORE, in consideration of the exchange of promises and covenants herein contained, the legal sufficiency of which is hereby acknowledged, the Settling Parties agree, subject to approval by the Authority, as follows:

AUTHORITY APPROVAL

1. **Merger Approval** – The Settling Parties agree that the Proposed Transaction, as supplemented, modified or superseded by this Settlement Agreement, is consistent with Connecticut law and the public interest and should be approved by the Authority without additional conditions. This Settlement Agreement is contingent upon the Authority's approval of this Settlement Agreement.

MERGER-RELATED DIRECT ECONOMIC BENEFITS

2. **Customer Rate Credits** – The Applicants will provide \$20 million in customer rate credits in the aggregate to customers of The United Illuminating Company (“UI”), Connecticut Natural Gas Corporation (“CNG”) and The Southern Connecticut Gas Company (“SCG” and collectively with CNG and UI, the “UIL Utilities”) in the first year following the closing.
 - a. OCC recommends the following approach for allocating the \$20 million among the three UIL Utilities: A one-time, \$20 million rate credit to customers will be allocated to UI, SCG and CNG based on the total number of retail customers at each utility in proportion to the total number of retail customers of the three UIL Utilities. Each Company's rate credit will be allocated to firm retail customer classes (i.e., residential, commercial and industrial) based upon their proportional share of the monthly customer charges, and will appear on the bill as a uniform dollar amount credit for each separate customer class as a separate line item, along with an explanatory bill message. All customers within a retail customer class shall receive the same rate credit dollar amount. The rate credits will be applied to billing cycles in or before the third full billing month following the closing of the Proposed Transaction.
3. **Additional Ratepayer Benefits for CNG Customers** – The Applicants will provide \$12.5 million in rate credits to customers of CNG over the ten-year period of 2018-2027 (\$1.25 million per year).
4. **Additional Ratepayer Benefits for SCG Customers** – The Applicants will provide the following benefits to customers of SCG:
 - a. \$1.6 million in ratepayer savings associated with doubling SCG's bare steel/cast iron main replacement (from \$11 million per year to \$22 million per year) over a three-year period without seeking recovery until the next SCG rate case.
 - b. \$7.5 million in rate credits over the ten-year period of 2018-2027 (\$0.75 million per year).
5. **Base Rate Freezes** – The Applicants commit to distribution base rate freezes for the UIL Utilities, which will result in significant customer savings. Specifically:

- a. UI's current distribution base rates will remain with no new distribution base rates in effect before at least January 1, 2017; and
 - b. CNG's and SCG's respective current distribution base rates will remain with no new distribution base rates in effect before at least January 1, 2018.
6. **Clean Energy Fund** – The Applicants will provide \$2 million per year for a three-year period following closing to the State of Connecticut Department of Energy and Environmental Protection ("DEEP") to be used to stimulate public and private investment in energy efficiency, renewable generation, storage, alternative transportation, electric vehicles and other clean technologies.
7. **Storm Resiliency** – Within 6 months after closing, UI will submit a multi-year plan and cost recovery mechanism to the Authority for spending on additional distribution system resiliency. The program will be subject to the Authority's review and approval. Subject to such approval, UI commits that all investment will be made in a timeframe approved by the Authority. UI will commit to seeking the following rate treatment for the first \$50 million in such spending: UI will be allowed to recover the revenue requirements associated with the investment through the system benefits charge, federal mandated congestion charge or similar mechanism, but for the period of two years following completion of the investment, for the equity portion of the investment, UI will not recover the difference between (a) the cost of equity and (b) the cost of debt, which will result in an estimated UI customer benefit of \$5 million.
8. **Customer Disaster Relief** – The Applicants commit to provide \$1 million for disaster relief needs for Connecticut residents through entities such as the Connecticut Coordinated Assistance and Recovery Endowment (CT CARE).
9. **Charitable Contributions** – UIL and the UIL Utilities will maintain their current charitable giving and corporate philanthropy programs for at least four years (based upon historical annual contribution levels of between \$500,000 to \$800,000).
10. **Hirings** – During the three years following closing, the Applicants commit to hire 150 people in the State of Connecticut (to the extent such people are hired as contractors, such contracts will be multi-year).
11. **English Station** – UI has signed a Proposed Partial Consent Order ("Consent Order") that, when approved by the Commissioner of DEEP and subject to the closing of the Proposed Transaction and other terms and conditions in the Consent Order, requires UI to investigate and remediate certain environmental conditions within the perimeter of the English Station site. To the extent that the investigation and remediation is less than \$30 million, UI will remit to the State of Connecticut the difference between such costs and \$30 million for a public purpose as determined in the discretion of the Governor, the AG, and the Commissioner of DEEP. The remediation will benefit the City of New Haven, and will further the State's broader goals of revitalizing contaminated sites. Accordingly, this would provide a public interest benefit estimated at \$30 million.

12. Litigation –

- a. OCC will withdraw its appeal of Docket No. 13-06-08 upon the expiration of the time period for appeal of the order approving the settlement agreement if no appeal has been taken, or such earlier date as all docket participants agree that no appeal will be taken. The Authority will issue a supplemental decision in Docket No. 13-06-08 to remove the requirement that CNG file a private letter ruling request by CNG with the Internal Revenue Service as all issues have been resolved.
- b. UI will withdraw its appeals of Docket Nos. 99-03-35RE20 and 14-02-01 upon the expiration of the time period for appeal of the order approving the settlement agreement if no appeal has been taken, or such earlier date as all docket participants agree that no appeal will be taken.
- c. The Authority's approval of this Settlement Agreement shall resolve all issues related to the transaction approved by the Authority in Docket No. 10-07-09.

CUSTOMER SERVICE QUALITY BENEFITS

- 13. **Customer Service Quality** – The UIL Utilities will improve the following customer service metrics by 5% by the end of the third calendar year following closing: (a) average answering times; (b) % abandoned calls; and (c) % appointments met. In the event that such commitments are not met, the Authority will hold a regulatory proceeding and determine any penalties to be imposed.
- 14. **Safety and Reliability Quality** – The Applicants will maintain the high level of safety and reliability (determined as the average of the four preceding calendar years) as measured by SAIDI and SAIFI for UI and by gas leak response and third party damage for SCG and CNG. In the event that such commitments are not met, the Authority will hold a regulatory proceeding and determine any penalties to be imposed.

MAINTAINING LOCAL MANAGEMENT

15. Local Management –

- a. There will be no changes to the day-to-day management and operation of the UIL Utilities as a result of the Proposed Transaction.
- b. The UIL Utilities will retain their current authority and decision-making.
- c. There will be no reductions to any of the Grants of Authority currently in effect for UIL and the UIL Utilities.

- d. A new management position will be created, the President of Connecticut Operations, who will come from the existing management team of UIL or the UIL Utilities.
- e. The President of Connecticut Operations will be headquartered in Connecticut, along with people involved in the management of UIL and the UIL Utilities (regardless of the entity at which they will ultimately be employed).
- f. There will be no involuntary terminations, except for cause or performance, in the State of Connecticut for at least three years after closing.
- g. A Connecticut resident will be named to the Networks board of directors. This person will be an independent (i.e., non-management) director.
- h. The Applicants will support a management audit of any of the UIL Utilities following closing of the Proposed Transaction and note that any such audits may be most useful if initiated following the integration of the UIL Utilities, or shortly before the end of the second year following closing of the Proposed Transaction.
- i. The Applicants commit to include the service territories of the UIL Utilities in the group of locations where meetings of IUSA's and Networks' boards of directors and management are held.
- j. The Applicants commit that the interests of UI and the State of Connecticut will be given substantial consideration in the ISO-NE stakeholder processes. Either the Applicants' member or alternate on the NEPOOL Participants Committee will be from the State of Connecticut.
- k. IUSA intends to maintain its ownership of UIL and the UIL Utilities and is committed to the State of Connecticut. The Applicants have no plans to sell the UIL Utilities and acknowledge that any such sale in the future would require approval by the Authority.

RING-FENCING MEASURES AND
ADDITIONAL LOCAL MANAGEMENT COMMITMENTS

16. **Special Purpose Entity** – Following the consummation of the Proposed Transaction, the Applicants will create a tax neutral special purpose entity ("SPE") that is a direct, wholly-owned subsidiary of Networks. The SPE will have four directors appointed by IUSA. One of the four SPE directors will be an independent director, who will be an employee of an administration company in the business of protecting SPEs, and must meet the other independence criteria set forth in the SPE governing documents. One other director will be appointed from among the officers or employees of UIL or a UIL subsidiary. The other two SPE directors may be officers or employees of IUSA or its affiliates, including UIL and its subsidiaries. The SPE will directly own 100% of the ownership interests in

UIL and function as the intermediate holding company separating UIL and its subsidiaries, including the UIL Utilities, from the IUSA Affiliates. The SPE will operate so as to provide protection to UIL and the UIL Utilities from bankruptcy proceedings of the IUSA Affiliates. The SPE will have no other operational functions, and none of the cost of establishing, operating or modifying the SPE will be recovered from the UIL Utilities' customers.

17. **Separate Corporate Existence** – At all times, the SPE will maintain its separate existence as a separate corporate subsidiary of Networks, UIL will maintain its separate existence as a separate corporate subsidiary of the SPE, and each of the UIL Utilities will maintain their separate existences as separate corporate subsidiaries of UIL with their separate utility franchises, obligations and privileges. At all times, each of UIL and the UIL Utilities will hold themselves out as an entity separate from its affiliates, will conduct business in its own name through its duly authorized directors and officers, comply with all organizational formalities to maintain its separate existence and shall use commercially reasonable efforts to correct any known misunderstanding regarding its separate identity.
18. **Separate Books and Records; Authority Access to Books and Records** – UIL, the UIL Utilities and the SPE will each maintain separate books, records, bank accounts and financial statements reflecting its separate assets and liabilities. Upon request, the Applicants agree to provide the Authority and its Staff and OCC access in the State of Connecticut to UIL's and the UIL Utilities' original books and records as maintained in the ordinary course of business within twenty working days after such request.
19. **No Cross-Default** – None of the UIL Utilities will include a condition in their debt agreements that would cause a default as a result of the default of an affiliate's debt, other than the existing limited provisions (or similar successor provisions) as required by bondholders related to ERISA compliance.
20. **Arm's-Length Relationships** – UIL, the UIL Utilities and the SPE will maintain arm's-length relationships with each of their affiliates and observe all necessary, appropriate, and customary company formalities in their dealings with their affiliates.
21. **No Commingling of Funds** – The SPE will not commingle its funds or other assets with the funds or other assets of any other entity and shall not maintain any funds or other assets in such a manner that it will be costly or difficult to segregate, ascertain or identify its individual funds or other assets from those of its owners or any other person.
22. **Separate Debt/Preferred Stock** – Each of the UIL Utilities will maintain separate debt, and, for CNG, separate preferred stock, so that none will be responsible for the debts or preferred stock of affiliated companies.
23. **No Assumption of Debt** – With respect to any acquisition by any affiliated companies, none of UIL or the UIL Utilities will incur or assume any debt, including the provision of guarantees, pledges or collateral support. UIL and its operating utilities will not incur or assume any debt, including the provision of guarantees or collateral support, related to

this merger or any future IUSA or Iberdrola acquisition. The SPE will not incur or assume any debt, including the provision of guarantees, pledges or collateral support, unless otherwise approved by the Authority.

24. **Money Pools** – The UIL Utilities may only participate in money pools where the other participants in such money pools are other regulated utility affiliates in the United States unless otherwise authorized by the Authority. Notwithstanding the foregoing, UIL may participate in such money pool as a lender but not as a borrower.
25. **Registration with Credit Rating Agencies** – Each of IUSA and the UIL Utilities shall register with at least two out of the three major nationally and internationally recognized bond rating agencies, such as Standard & Poor's, Moody's Investor Service, and Fitch Ratings, and intend to maintain at least an investment grade credit rating.
26. **Rating Agency Presentations** – Copies of all presentations made to credit rating agencies by IUSA or any of its affiliates that relate to UIL or the UIL Utilities must be provided, within ten business days of the presentation, to the Authority's Staff and OCC on a continuing basis, subject to appropriate confidentiality protections including a protective order.
27. **Internal Corporate Reorganization** – IUSA shall not engage in an internal corporate reorganization relating to UIL, the UIL Utilities or the SPE for which the Authority's approval is not required without 90 days prior written notification to the Authority. Such notification shall include: (a) an opinion of reputable bankruptcy counsel that the reorganization does not impact the effectiveness of UIL's existing ring-fencing; or (b) a letter from reputable bankruptcy counsel describing what changes to the ring-fencing would be required to ensure UIL is at least as effectively ring-fenced following the reorganization and a letter from IUSA committing to obtain a new non-consolidation option before the reorganization and to take any further steps necessary to obtain such an opinion. None of IUSA or its affiliates will object if the Authority elects to open an investigation into the matter if the Authority deems it appropriate. Notwithstanding the above language in this Paragraph, the Applicants shall not alter the ring-fencing plan described in these ring-fencing requirements without first obtaining approval in a written order from the Authority.
28. **GAAP** – The SPE and UIL will comply with U.S. generally accepted accounting principles ("GAAP") in all material respects (subject, in the case of unaudited financial statements, to the absence of footnotes and to normal year-end audit adjustments) in all financial statements and reports required of it and issue such financial statements and reports separately from any financial statements or reports prepared for its affiliates; provided, however, that such financial statements or reports may be consolidated with those of its affiliates if the separate existence of UIL and its assets and liabilities are clearly noted therein.
29. **Independent Board Members** – Networks will have a board of directors consisting of seven or more people. At least three of the members of the Networks board must be independent (as defined by New York Stock Exchange rules). At least one of the

independent directors will be a Connecticut resident. UIL's seven-member Board of Directors will include one director from the electric utility in Connecticut and one director from one of the gas utilities in Connecticut. The UIL Board of Directors will select the Board of Directors of the three regulated operating utilities, and those boards will choose the officers of each operating company.

30. **Golden Share –**

- a. The SPE will issue a non-economic interest (a "Golden Share") in the SPE to an administration company in the business of protecting special purpose entities and separate from the administration company retained to provide the person to serve as the independent director for the SPE. The holder of the SPE's Golden Share will have the right to vote on matters specified in the SPE governing documents, as described in this Paragraph.
- b. A voluntary petition for bankruptcy by the SPE will require the affirmative consent of the holder of the Golden Share as well as the affirmative vote of the SPE's board of directors, including the vote of the independent director on the SPE's board of directors. A voluntary petition for bankruptcy by UIL will require the affirmative consent of the holder of the Golden Share, the unanimous vote of the SPE's board of directors (including the independent director), and the unanimous vote of UIL's board of directors. A voluntary petition for bankruptcy for any of UIL's subsidiaries will require the unanimous vote of the UIL board of directors and the unanimous vote of the board of directors of the relevant UIL subsidiary.
- c. Any amendment to the organizational documents of the SPE that would remove or alter the voting or other ring-fencing requirements set forth in this document will require the affirmative vote of the SPE's board of directors and the affirmative consent of the holder of the Golden Share.

31. **Non-consolidation Opinion** – IUSA will obtain a legal opinion in customary form and substance, to the effect that, as a result of the ring-fencing measures it has implemented for UIL and its subsidiaries, a bankruptcy court would not consolidate the assets and liabilities of the SPE with those of IUSA, in the event of an IUSA bankruptcy, or the assets and liabilities of UIL or its subsidiaries with those of either the SPE or IUSA, in the event of a bankruptcy of the SPE or IUSA. In the event that such opinion cannot be obtained, IUSA will promptly implement such measures as are required to obtain such opinion.

32. **SPE and Non-consolidation Opinion Costs** – None of the cost of establishing, operating, or modifying the SPE will be borne by UIL or the UIL Utilities or the customers of the UIL Utilities. The cost of obtaining the opinion of legal counsel referred to in Paragraph 31 (or any future opinion) will not be borne by UIL or the customers of the UIL Utilities.

33. **Minimum Common Equity Ratio** – Each of the UIL Utilities is permitted to pay dividends in any year up to an amount equal to the sum of: (i) income available for common dividends generated in that year; (ii) the cumulative amount of retained earnings accrued in prior years starting with the closing date of this Proposed Transaction; and (iii) that portion of paid-in capital that was recorded on their respective books as unappropriated retained earnings, unappropriated undistributed earnings, and accumulated other comprehensive income immediately prior to the closing date of the Proposed Transaction, to the extent that those earnings have not already been paid out as dividends in years following the closing date of the Proposed Transaction; however, no dividends may be paid by a UIL Utility if payment would result in that UIL Utility being unable to maintain a minimum common equity percentage in its capital structure that is no lower than 300 basis points (3%) below the equity percentage used to set rates in the UIL Utility's most recent distribution rate proceeding (measured using a trailing 13-month average calculated as of the most recent quarter end), exclusive of goodwill. In addition to the aforesaid 300 basis point limitation, for the first six months after the closing date of the Proposed Transaction, a UIL Utility is precluded from paying dividends in excess of \$10 million that is funded from paid-in capital. Isolated events, such as mandated changes in accounting, that temporarily affect equity will be reported to the Authority and excluded from the common equity ratio calculation. This minimum equity ratio requirement will not have any impact on the Authority's right to establish equity ratios used for ratemaking purposes in future rate cases, and all parties as well as the Authority's Staff shall retain all rights to take positions, submit evidence and make arguments in those future rate cases about the appropriate equity levels for ratemaking purposes.
34. **Limitations on Dividends** –
- a. No UIL Utility shall make any distribution to its parent if the UIL Utility's corporate issuer or senior unsecured credit rating, or its equivalent, is rated by any of the three major credit rating agencies below investment grade.
 - b. No UIL Utility shall issue any dividend to its parent if such UIL Utility's corporate issuer or senior unsecured credit rating, or its equivalent, falls to the lowest investment grade rating and there is a negative watch or review downgrade notice for the company as determined by two of the three major credit rating agencies or, alternatively, if such credit rating falls below investment grade without such notice ("Ratings Event"). The UIL Utilities retain the right to petition the Authority for the ability to issue a dividend if such a Ratings Event occurs. This restriction will end when the Ratings Event ends, such that the relevant credit rating is restored, the negative watch or review notice is removed with no negative action taken, or the Authority or its designee specifically approves the payment of dividends or transfer of items of value.
 - c. Each UIL Utility shall file with the Authority an officer's certificate twice a year certifying that for that six-month period, each payment of a dividend, the calculations that it used to determine the equity level at the time the board of directors considered payment of the dividend and the calculations to demonstrate

that the common equity ratio immediately after the dividend payment did not fall below the Minimum Common Equity Ratio defined in Paragraph 33 above, as equity levels are calculated under the ratemaking precedents of the Authority. The calculations used by each UIL Utility will also be filed with the officer's certificate.

35. **Ratings Event** – If a Ratings Event described in Paragraph 34 occurs with respect to a UIL Utility:
- a. The company affected by that Ratings Event may not transfer, lease, or lend any moneys, assets, rights, or other items of value to any affiliate without first obtaining the Authority's approval. These provisions exclude payments for goods, services, and assets related to reasonable commitments made 180 days or more before the Ratings Event, routine transactions required in the regular course of business pursuant to contracts or other arrangements in existence 180 days or more before the Ratings Event, corporate taxes, and payments, if not accelerated, of principal or interest on loans.
 - b. The UIL Utility affected by that Ratings Event must file a plan with the Authority within 60 days explaining the actions that are planned to address and rectify the situation.
36. **UIL Senior Management** – UIL senior management will continue to establish priorities and respond to local conditions as it does today. UIL will continue to have the authority and responsibility to provide input into the development of the UIL Utilities' capital and operating and maintenance expense budgets and implement the approved budgets. While the UIL Utilities' budgets will be reviewed by Networks, they must also be approved by the UIL board of directors.
37. **Access to Senior Management** – As a member of the IUSA management team, UIL will meet with the IUSA CEO at least monthly and have direct and frequent access to him and other members of IUSA's senior management team.
38. **Connecticut Operations** – The UIL Utilities will continue to operate within the State of Connecticut as public utilities subject to the continuing jurisdiction of the Authority pursuant to the State of Connecticut's applicable statutes regulating public utilities, and without any reduction in the Authority's existing oversight or authority over the UIL Utilities.
39. **Corporate Governance Principles and Delegation of Authority** – The authority and responsibility delegated to local management will be clearly delineated in formal, written documents including a statement of Corporate Governance Principles and a Delegation of Authority ("DOA"). The DOA will demarcate, among other things, levels of expenditures and defined categories of decisions that can be authorized solely by the management of UIL and its regulated operating utilities with utility Board of Directors' approval. UIL's existing Grants of Authority document satisfies this DOA commitment. The references

to the "Board" in UIL's Grants of Authority mean UIL's Board of Directors. After closing, UIL's Board of Directors will ratify the existing Grants of Authority.

40. **Board and Shareholder Meetings** – IUSA's Board of Directors will include the UIL Utilities' service territories among the regular locations of IUSA's board and shareholder meetings.
41. **Management Meetings** – IUSA and Networks will include the UIL Utilities' service territories among the locations of their regular periodic management meetings.
42. **Delegations of Authority** – Delegations of authority will be established setting forth the authorizations of officers of UIL and its utility subsidiaries to act on behalf of UIL and its utility subsidiaries without further authorization from Networks or IUSA. The proposed delegations of authority for UIL and its utility subsidiaries will be set forth in that document. The delegations of authority for the regulated subsidiaries adopted by UIL will not be amended to reduce authorization levels of the regulated subsidiaries officers without prior notice to the Authority.
43. **SPE's Title to Real and Personal Property** – The SPE shall ensure that title to all real and personal property acquired by it is acquired, held and conveyed in its name.
44. **Timing, Implementation and Review** – The Applicants agree to implement the commitments set out above within 180 days of the consummation of the Proposed Transaction and will not modify or terminate any such commitments without first obtaining the Authority's approval. Ten years after the closing of the Merger, the Applicants shall have the right to review the provisions contained in this document, and to make a filing with the Authority requesting authority to modify or terminate those provisions. Notwithstanding such right, Applicants agree not to proceed with any such modification or termination without first obtaining the Authority's approval in a written order. The Applicants recognize that the Authority at any time may initiate its own review or investigation regarding ring-fencing measures (or upon petition by any party) and order modifications that it deems to be appropriate, in the public interest and in the best interest of the UIL Utilities' customers.
45. **Annual Compliance Report** – UIL will file with the Authority an annual compliance report with respect to the ring-fencing and other requirements certified by an executive thereof under penalty of perjury.
46. **Officer's Certificate** – At the time the SPE is formed and every year thereafter, UIL shall provide the Authority with a certificate from an officer of IUSA certifying that: (a) IUSA shall maintain the requisite legal separateness in the corporate reorganization structure; (b) the organization structure serves important business purposes for IUSA; and (c) UIL and its regulated subsidiaries will be kept separate to avoid substantive consolidation of UIL or its regulated subsidiaries with Networks or IUSA.
47. **Tracking Mechanisms** – UIL and the UIL Utilities will create internal tracking mechanisms to ensure compliance with these ring-fencing requirements and file with the Authority an annual compliance report with respect to such ring-fencing requirements.

AUTHORITY APPROVAL AND OTHER CONDITIONS

48. **Settlement Approval** – The Settling Parties assert that, if the Authority does not approve this Settlement Agreement in its entirety this filing shall be deemed to be withdrawn and shall not constitute a part of the record in any proceeding or used for any other purpose. If the Authority does not so approve this Settlement Agreement, the Settling Parties reserve their respective rights to pursue approval of the Application and/or their respective positions thereon as if this Settlement Agreement never existed.
49. The provisions of this Settlement Agreement are not severable. This Settlement Agreement is conditioned on its full approval by the Authority without additional conditions or requirements.
50. If, for any reason, the Proposed Transaction is not consummated, the terms of this Settlement Agreement shall be null and void and no longer apply even if already approved by the Authority subject to the terms set forth herein.
51. This Settlement Agreement shall not be deemed in any respect to constitute an admission by any party that any allegation or contention in this proceeding is true or false. Except as specified in this Settlement Agreement to accomplish the customer benefit intended by this Settlement Agreement, the entry of an order by the Authority approving the Settlement Agreement shall not in any respect constitute a determination by the Authority as to the merits of any other issue raised in this proceeding.
52. The making of this Settlement Agreement establishes no principles and shall not be deemed to foreclose any party from making any contention in any proceeding or investigation, except as to those issues and proceedings that are resolved and terminated by approval of this Settlement Agreement.
53. This Settlement Agreement is the product of settlement negotiations. The Settling Parties agree that the content of those negotiations (including any workpapers or documents produced in connection with the negotiations) are confidential, that all offers of settlement are without prejudice to the position of any party or participant presenting such offer or participating in such discussion, and, except to enforce rights related to this Settlement Agreement, comply with the Connecticut Freedom of Information Act or defend against claims made under this Settlement Agreement, that they will not use the content of those negotiations in any manner in these or other proceedings involving one or more of the parties to this Settlement Agreement, or otherwise.
54. Any number of counterparts of this Settlement Agreement may be executed, and each shall have the same force and effect as an original instrument, as if all the parties to all the counterparts had signed the same instrument.

The signatures listed below represent that they are authorized on behalf of their principals to enter into this Settlement Agreement.

OFFICE OF CONSUMER COUNSEL

By: Elin Swanson Katz / UPA
Elin Swanson Katz
Consumer Counsel
Office of Consumer Counsel
Ten Franklin Square
New Britain, CT 06051

**IBERDROLA, S.A.
IBERDROLA USA, INC.
IBERDROLA USA NETWORKS, INC.
GREEN MERGER SUB, INC.**

By: _____
David L. Schwartz
Latham & Watkins LLP
555 11th Street NW, Suite 1000
Washington, DC 20004

*Counsel for Iberdrola, S.A., Iberdrola
USA, Inc., Iberdrola USA Networks, Inc.
and Green Merger Sub, Inc.*

UIL HOLDINGS CORPORATION

By: _____
Linda L. Randell
Senior Vice President and
General Counsel
UIL Holdings Corporation
157 Church Street
New Haven, CT 06510

Date: September 18, 2015

The signatures listed below represent that they are authorized on behalf of their principals to enter into this Settlement Agreement.

OFFICE OF CONSUMER COUNSEL

By: _____

Elin Swanson Katz
Consumer Counsel
Office of Consumer Counsel
Ten Franklin Square
New Britain, CT 06051

**IBERDROLA, S.A.
IBERDROLA USA, INC.
IBERDROLA USA NETWORKS, INC.
GREEN MERGER SUB, INC.**

By: _____

David L. Schwartz
Latham & Watkins LLP
555 11th Street NW, Suite 1000
Washington, DC 20004

*Counsel for Iberdrola, S.A., Iberdrola
USA, Inc., Iberdrola USA Networks, Inc.
and Green Merger Sub, Inc.*

UIL HOLDINGS CORPORATION

By: _____

Linda L. Randell
Senior Vice President and
General Counsel
UIL Holdings Corporation
157 Church Street
New Haven, CT 06510

Date: September 18, 2015



STATE OF CONNECTICUT
PUBLIC UTILITIES REGULATORY AUTHORITY

Attachment RCS-10
Docket Nos. W-01732A-15-0131 &
W-01303A-15-0131
Page 1 of 3

May 9, 2014
In reply, please refer to:
Docket No. 13-06-08
Order No. 17

Michael Coretto
Connecticut Natural Gas Corp.
157 Church Street
PO Box 1564
New Haven, CT 06506

Re: Docket No. 13-06-08 - Application of Connecticut Natural Gas Corporation for a Rate Increase

Dear Mr. Coretto:

The Public Utilities Regulatory Authority (Authority) received the Connecticut Natural Gas Company's (CNG or Company) March 14, 2014 Compliance Filing for Order No. 17 of the January 22, 2014 Decision in this proceeding (Decision).

Order No. 17 requires that the Company "seek a private letter ruling with regards to the specific question of, after extinguishment of an ADIT balance, whether or not a PUC directive to institute a ratemaking mechanism to reflect a credit to ratepayers of ADIT benefits lost through a 338(h)(10) election would constitute a normalization violation. The Company shall file proposed draft PLR to the PURA, for approval, no later than March 14, 2014." Order No. 17 relates to discussion of the Accumulated Deferred Income Tax (ADIT) in Section II.B.5 of the Decision. See, Decision, pp. 9-19. The Authority concluded that additional information, in the form of guidance from the United States Internal Revenue Service (IRS), was needed to make a final determination on this issue. To that end, the Authority determined that the appropriate course of action was to direct CNG to seek a Private Letter Ruling from the IRS. Order 17 directs CNG to file with the Authority for its review and approval a proposed request for a Private Letter Ruling from the IRS.

The Authority has reviewed and revised the IRS Private Letter Ruling request proposed by CNG. The Authority's revisions to the letter accomplish several key objectives. The revisions are aimed at making the request for a ruling even-handed, neutral, fair, open and transparent on the applicability of the Depreciation Normalization rules contained in 26 U.S. Code § 168(i)(9) and Treas. Reg. §1.167(l)-1, to the ADIT issue raised in this proceeding. The Authority insists that the letter sent to the IRS

10 Franklin Square, New Britain, CT 06051

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provide a clear and concise statement of the issue without any advocacy by CNG for its particular position.

After the Authority reviews comments, the Authority will issue a letter ruling on the Company's Order No. 17 Compliance filing.

CNG's proposed letter was more of a CNG advocacy piece containing its legal theory for why the IRS should find a normalization violation. The CNG proposed letter also unfairly provided that CNG's expert witness on this issue in Docket No. 13-06-08, was also representing CNG, before the IRS.

The Authority's revision to the Company's letter removes CNG's language referencing the investment tax credit normalization rules and advocating for a finding of a normalization violation. The Authority's revision to the Private Letter Ruling Request removes CNG's expert witness from having a role in representing the Company before the IRS. The Authority is concerned with the ability of this tax attorney to present this issue before the IRS in an unbiased manner and requests the Company employ its in-house counsel before the IRS. The Authority questions CNG's use of the same tax attorney both as an expert witness before the PURA advocating a particular position and as a representative for CNG before the IRS in this Private Letter Ruling process unless the intent is to persuade the IRS to rule consistently with the Company's position presented in Docket No. 13-06-08. In the opinion of the Authority, the IRS should consider this issue from more than the perspective of CNG's shareholders.

The Authority has sought a Private Letter Ruling to assist the PURA in its decision making. The Private Letter Ruling request is not intended for CNG to control the Private Letter Ruling process. The PURA is requiring CNG, the taxpayer, to seek this ruling because the Authority requires IRS input on a tax accounting issue in order to make a full and final determination on the ADIT issue raised in Docket No. 13-06-08. Therefore, CNG is acting in its capacity as a regulated public service company under the oversight and direction of the PURA in seeking this Private Letter Ruling. If the IRS requires additional information or wishes to learn the positions of the affected entities, the PURA, CNG and the Office of Consumer Counsel (OCC), should be able to participate in the IRS process on an equal basis. To that end, the Authority's revisions provide for greater transparency and equity to the PURA and the OCC by including them in the discussions between CNG and the IRS and by giving the PURA and the OCC the opportunity to participate in any conferences held by the IRS on this matter.

The Authority seeks comments on the attached version of IRS Private Letter Ruling request on the ADIT issue on or before May 19, 2014 at 12 Noon.

Sincerely,

PUBLIC UTILITIES REGULATORY AUTHORITY

Nicholas E. Neeley
Acting Executive Secretary

cc: Service List

ORIGINAL



0000166699

EXHIBIT

2-2
ADMITTED

BEFORE THE ARIZONA CORPORATION COMMISSION
RECEIVED

COMMISSIONERS

SUSAN BITTER SMITH, *Chairman*

BOB STUMP

BOB BURNS

DOUG LITTLE

TOM FORESE

DOCKETED

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AZ CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE JOINT APPLICATION OF
WILLOW VALLEY WATER CO., INC. AND EPCOR
WATER ARIZONA, INC. FOR APPROVAL OF THE
SALE OF ASSETS AND TRANSFER OF CERTIFICATE
OF CONVENIENCE AND NECESSITY

DOCKET NO. W-01732A-15-0131
DOCKET NO. W-01303A-15-0131

**Willow Valley's Response in
Opposition to RUCO's Request to
Reschedule Hearing**

Willow Valley Water Co., Inc. ("Willow Valley") responds in opposition to RUCO's "Request for an Extension of Time to File Surrebuttal Testimony, to Reschedule Evidentiary Hearing and Objection to Affidavit of Mike Liebman filed on November 3, 2015", filed by RUCO on November 4, 2015. RUCO proposes to reschedule the hearing during the week of Thanksgiving, which is infeasible. In addition, RUCO fails to provide a valid reason to modify the previously-agreed procedural schedule approved in the Commission's September 3, 2015 Procedural Order. However, Willow Valley does not object to a shorter extension to accommodate RUCO. Lastly, Willow Valley will not be offering Mr. Liebman's affidavit into evidence; accordingly RUCO's "objection" is without any basis.

I. Scheduling issues.

Public notices have already been published and mailed to customers with the November 16, 2015 hearing date. RUCO states that the "Company has recently filed new information on the ADIT issue regarding the tax normalization rule and RUCO needs time to analyze the issue." This is a reference to Mr. Walker's Rebuttal Testimony, which expressed concern that the ADIT "regulatory liability" proposed by RUCO would violate IRS tax normalization requirements. [See Walker Rebuttal at pages 3-7]. RUCO should have researched and understood the impacts of its

1 proposal on EPCOR and its ratepayers before filing its Direct Testimony. Moreover, the existing
2 schedule allows RUCO two full weeks to respond to the Rebuttal Testimony.

3 RUCO also states “[n]ew information was also filed on the acquisition premium, to which
4 RUCO needs time to do additional discovery to seek clarification on how it works.” This is
5 apparently a reference to the Rebuttal Testimony of EPCOR witness Sarah Mahler. The details of
6 EPCOR’s acquisition adjustment proposal were filed in the docket on June 1, 2015. RUCO has
7 had ample opportunity to conduct discovery—in fact, RUCO has issued numerous data requests
8 on the acquisition premium and various other topics.

9 RUCO also argues that this “is not a rate case and subject to time clock considerations”.
10 [RUCO Request at page 2, lines 10-11]. Although the rate case timeclock does not apply, the
11 Commission’s CC&N rules have a timeclock that applies to this CC&N transfer case. See A.A.C.
12 R14-2-411.C. That rule expressly refers to the licensing timeframe requirement in A.R.S. § 41-
13 1072. The Legislature has required all agencies to put in place licensing timeframes under A.R.S.
14 § 41-1072 to 41-1079, and a CC&N is a type of license. See A.R.S. § 41-1001(12), which defines
15 “license” as “includes the whole or part of any agency permit, certificate, approval, registration,
16 charter or similar form of permission required by law, but does not include a license required
17 solely for revenue purposes.” Staff expressly referred to the licensing timeframe in R14-2-411.C
18 in its sufficiency letter filed July 30, 2015, and the Commission’s August 14 Procedural Order
19 granted a 60 day extension to the timeclock or licensing timeframe, thus demonstrating that it
20 applies to this case. [August 14, 2015 Procedural Order at page 2, lines 6-8].

21 Lastly, RUCO notes that its administrative assistant will be out on November 12 to 13.
22 RUCO employs a highly qualified team of accountants and lawyers. Willow Valley is confident
23 that RUCO can continue its operations. Moreover, Willow Valley notes that its employees have
24 been performing their functions for months without certainty of continued employment, in light of
25 the pending transaction. The Procedural Order has been issued, and all the witnesses as well as
26 the public are on notice to be available at this time.
27

1 RUCO has not demonstrated any need for an extension of time. In addition, RUCO's
2 proposal is to move the hearing to the week of Thanksgiving. Willow Valley is unsure whether all
3 the witnesses and the ALJ will be available that week, as many people may already have travel
4 plans at that time. In addition, public notices have already been published and mailed to
5 customers with the November 16 hearing date.

6 As a compromise, Willow Valley proposes the following alternative. The existing
7 November 16 hearing date should be kept for public comment purposes only. The evidentiary
8 portion of the hearing can take place during the already scheduled hearing dates at the end of that
9 week, November 19 and 20. These dates have been in place for months, so all the witnesses
10 should be available then. If this is done, the surrebuttal testimony for Staff and RUCO can be
11 extended to November 13, 2015, giving RUCO an additional week.

12 **II. Liebman Affidavit.**

13 RUCO's filing also contains an "objection" to Mr. Liebman's affidavit. RUCO expresses
14 concern about Mr. Liebman's affidavit being offered into evidence, and that Mr. Liebman will not
15 be subject to cross-examination. Willow Valley does not intend to offer the affidavit into
16 evidence as an exhibit at the hearing. Rather, the affidavit was prepared and filed to respond to a
17 specific request from Commission Staff. Staff noted that Mr. Walker is not a tax expert and is not
18 Global employee, and thus Staff requested a signed affidavit from Global Water's CFO
19 confirming certain statements in Mr. Walker's testimony. Accordingly, Willow Valley submitted
20 the affidavit of Michael Liebman, Global Water's CFO, attesting to his agreement with certain
21 statements in Mr. Walker's testimony. The affidavit was submitted for Staff's use in reviewing
22 and analyzing Mr. Walker's testimony. Willow Valley may elect to have Mr. Liebman adopt
23 some portions of Mr. Walker's Rebuttal Testimony at the hearing. In that case, Mr. Liebman will,
24 of course, be subject to cross-examination.

25 Accordingly, RUCO's "objection" appears to be based on a misunderstanding, and should
26 be denied as moot.

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1 Original AND 13 copies of the foregoing
2 Hand-delivered this 5th day of November 2015, to:

3 The Arizona Corporation Commission
4 Utilities Division – Docket Control
5 1200 West Washington
6 Phoenix, AZ 85007

7 Copies of the foregoing hand-delivered/mailed
8 this 5th day of November 2015, to:

9 Scott M. Hesla
10 Administrative Law Judge
11 Hearing Division
12 Arizona Corporation Commission
13 1200 West Washington
14 Phoenix, AZ 85007

15 Thomas Broderick
16 Director, Utilities Division
17 Arizona Corporation Commission
18 1200 West Washington
19 Phoenix, AZ 85007

20 Janice Alward, Esq.
21 Chief Counsel, Legal Division
22 Arizona Corporation Commission
23 1200 West Washington
24 Phoenix, AZ 85007

25 Daniel Pozefsky
26 Residential Utility Consumer Office
27 1110 W. Washington Street, Suite 220
Phoenix, AZ 85007

Thomas Campbell
Stanley B. Lutz
Lewis Roca Rothgerber, LLP
201 E. Washington Street
Phoenix, AZ 85004

By Jaclyn Howard

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming, Global Water Resources, Inc.
Title: CEO

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 6.02

Page 1 of 2

Q. Capital Investments – On page 3, line 5, of Mr. Bradford's testimony he has identified 6 projects that will reduce water loss and improve the overall operability of the Willow Valley System. Admit or deny that Global Water cannot perform the same capital improvements. If Admit please explain why Global Water cannot make the necessary capital investments?

A. Global Water can perform the same capital improvements; however, such improvements will not be made on the same timetable as proposed by EPCOR. Global Water Resources, Inc. (Global Water) has invested approximately \$3.3 million into new infrastructure for Willow Valley since 2006, including essential improvements that corrected grave water quality issues that posed a significant public health risk. Each year that Global Water has owned Willow Valley, it has experienced a financial loss. This makes attracting capital investment into the system difficult. In light of its longstanding losses and significant investments already made into Willow Valley, Global Water will not be pursuing capital improvements to the Willow Valley system on the same rapid timetable as EPCOR is proposing.

Despite these factors, Global Water fully intended to move forward with the SIB Capital Improvement Program which included the removal and replacement of aging waterline infrastructure, which is the best course to reduce water loss at this stage, as previously documented. However, RUCO's litigation against the SIB mechanism has had a very negative impact on the timing for distribution system replacement projects for Willow Valley.

Willow Valley is a small system with 1,600 customers. In contrast, EWAZ's Mohave and North Mohave systems have approximately 19,000 customers.¹ EWAZ, as Mr. Becker of the Arizona Corporation Commission explained, "has a capital structure that is more favorable to the rate payers." (Becker Direct at page 10, line 9.) While we are confident in the work and manner in which we

¹ According to Decision No. 74174 (October 25, 2013), EWAZ's Mohave System had approximately 17,000 customers, and the system acquired from North Mohave Valley Corporation had approximately 2,000 customers.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

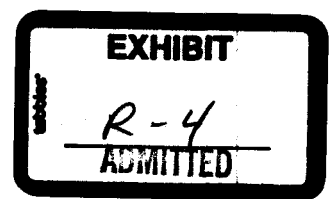
Response provided by: Ron Fleming, Global Water Resources, Inc.
Title: CEO

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 6.02

Page 2 of 2

improved and currently operate Willow Valley as well as our ability to perform additional improvements, EWAZ can operate Willow Valley more effectively and efficiently and is willing to pursue an accelerated Capital Improvement Program, which ultimately benefits the ratepayers.



COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Objection provided by: Timothy J. Sabo, Snell & Wilmer L.L.P.

Response provided by: Paul Walker, Consultant to Global Water Resources, Inc.

Title: President, Insight Consulting, LLC

Address: 21410 N. 19th Ave., Suite 220,
Phoenix, AZ 85027

Company Response Number: RUCO 6.01

Q: Global Water Consultant Paul Walker – Please provide a copy of any papers, power point presentations, etc. authored in the past by Mr. Walker, excluding the white paper already cited in Mr. Michlik's testimony.

A. Objection. This request is unreasonably overbroad; it is not limited to in time, by topic, or by geographic region. Mr. Walker's 7th grade papers would be included in the request, but would be irrelevant to the proceedings. Similarly, power point presentations prepared by Mr. Walker during his military service are not relevant, and may in some cases be classified or otherwise unavailable. Likewise, materials prepared by Mr. Walker during his time as advisor for then-Commissioner/Chairman Spitzer may be confidential or protected by the deliberative process privilege.

Notwithstanding this objection, Willow Valley agrees to provide a set of papers and power-point presentations by Mr. Walker presented or delivered in Arizona related to the following utility matters after he left the Commission: Acquisitions and ADIT. Mr. Walker has employed reasonable efforts to find all such documents, but given his active speaking schedule and the numerous matters he has been involved in over the years, there can be no guarantee that all such documents were located. The documents have been Bates numbered 00875 to 00928 and are provided on the enclosed CD.

Acquisition Adjustments and Rate Premia

Acquisition Adjustments: An increase to utility rate base which reflects the cost of the purchase of the utility or the asset.

Rate Premium: An increase to the allowed return on equity as an incentive for certain investments.

CAVEAT

- Groups who will not agree with this presentation:
- Parties which support Acquisition Adjustments and Rate Premia as regulatory means to encourage consolidation,
- Parties which expect Utility shareholders to “foot the bill” for consolidation,
- Parties looking for an easy solution.
- The purpose of this presentation is not to be the “skunk at the picnic” but to provide investment perspective on the suggested tools.

Presented to ACC Water
Workshop Feb 12, 2013

Basis for Opinion

- 11 years' experience at the ACC, four as advisor to Commissioner and Chairman Marc Spitzer,
- 7 years' experience advising Wall Street firms on utility acquisition cases in several states,
- 7 years' experience working with regulated water and wastewater companies,
- 4 years' experience assisting with acquisitions in Arizona.

Presented to ACC Water
Workshop ~~Feb. 15, 2001~~ ^{Feb. 15, 2003}

Acquisition Adjustments

- Staff Testimony in Global's rate case (2010):
- Q: And can you tell me how many times you are aware of that the Commission has approved a positive acquisition adjustment relating to the acquisition of a small water company by a large water company or utility holding company?
- A: Two. [Tr. Page 788 - 789]

Acquisition Adjustments

- Staff Testimony in Global's rate case (2010):
- Q: Two. Could you specify what those were?
- A: [Algonquin]... and previous to that – it's just because I've been here so long – there was a small company called Cool Wells in what is now, in the Sun City area. And Citizens bought it. He had 11 customers... and Citizens bought it for something like \$10,000 and the Commission gave citizens the acquisition adjustment." [Tr. Page 789]

Presented to ACC Water

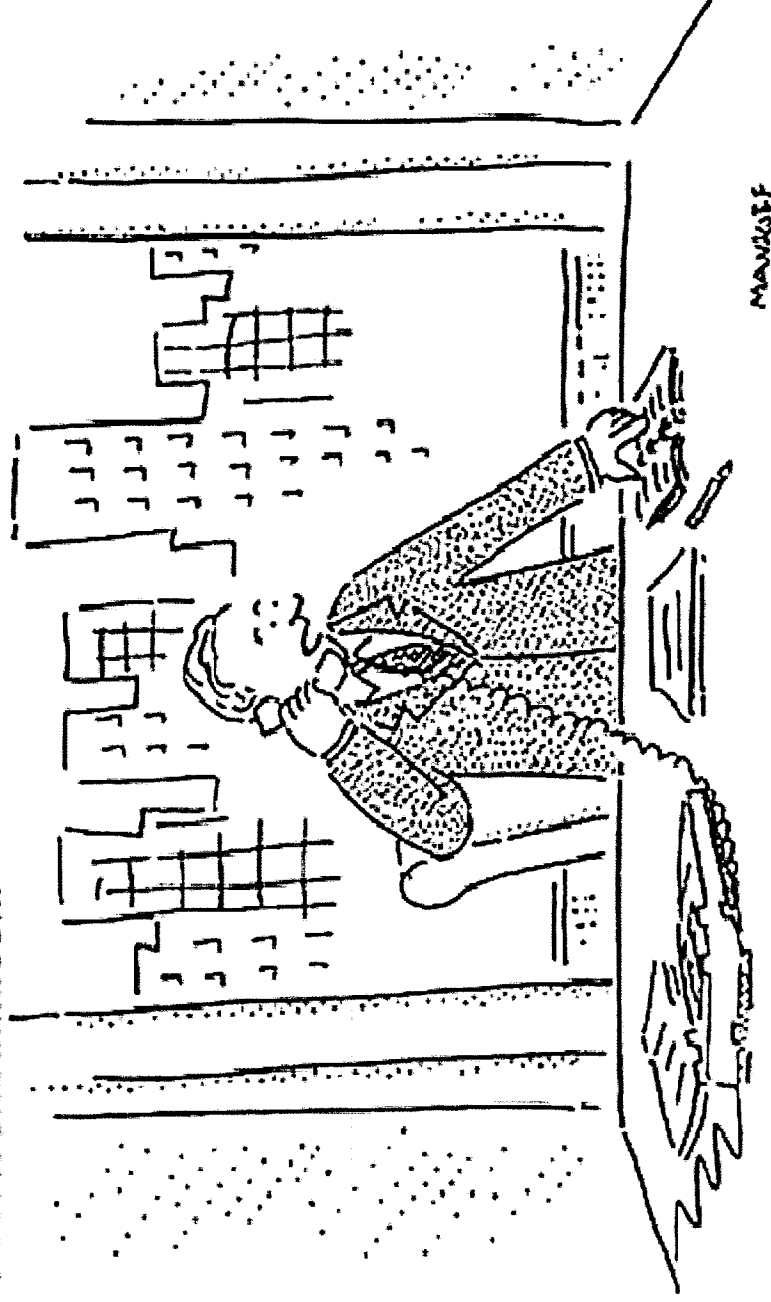
Workshop Feb 12, 2018

Acquisition Adjustments

- RUCO Testimony in Global's rate case (2010):
 - Q: [Did RUCO ever] propose or support an acquisition adjustment?
 - A: No. And RUCO wouldn't have because typically the Commission doesn't allow acquisition adjustments to be included in rate base... [Tr. Page 658]
 - Q: And have you ever testified in support of an acquisition adjustment in any proceeding whatsoever?
 - A: None that I'm aware of. [Tr. Page 658]

Acquisition Adjustments

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"No, Thursday's out. How about never—is never good for you?"

Presented to ACC Water
Workshop Feb 11 2011

Acquisition Adjustments – Recommended Policy Language

- “Acquisition adjustments are a potentially useful tool that the Arizona Corporation Commission may, in limited circumstances, approve in order to encourage the acquisition of a troubled utility.”

Presented to ACC Water
Workshop Feb 12, 2011

A Rate Premium

• AUTHORIZED ROE

+

• ROE PREMIUM

=

• COST OF EQUITY

The theory is to provide a return *above the market level* in order to attract investment.

Staff Testimony on Rate Premia in Global Rate Case

Q. Okay. And then in the next sentence it lists possible methods, other methods of encouraging consolidation, **such as rate of return, premiums, or deferred accounting orders**; is that right?

A. I see that.

Q. **To your knowledge, how often has Staff recommended either of those alternative methods in acquisitions?**

A. **There may have been a deferral** when -- when Arizona-American acquired Citizens there wasn't a determination. Arizona-American wanted a determination that they would get the acquisition adjustment in rate base...

Q. Okay. And, to your knowledge, was Arizona-American ever successful in getting that acquisition premium?

A. I don't think they were.

Q. **And other than that possible example, to your knowledge, how often has the Commission approved either those methods in acquisitions?**

A. I don't know of any. [Tr. Page 835]

Rate Premia in Arizona – “Average” is not an incentive

- Arizona has consistently ranked as one of the Bottom 5 states for utility investment climate
 - Standard & Poors’ “Assessment of Regulatory Climate for Investor Owned Utilities” reports
- Public Utility Reports’ November 2010 ROE survey shows that Arizona was the only state in the nation handing out 8% ROEs

Rate Premia in Arizona – “Average” is not an incentive

- Arizona’s average ROE of 9.29 in 2010 was lower than 99.2% of the ROEs granted nationwide
 - Public Utilities Report, ROE Survey, November 2010

Presented to ACC Water
Workshop Feb 11, 2015

Rate Premia in Arizona – “Average” is not an incentive

- S&P ~ 85% of U.S. IOUs are investment grade
- Arizona Regulated Utilities
 - APS: BBB- (lowest investment grade)
 - TEP: BB+ (below investment grade)
- Arizona’s non-Regulated Utility
 - Salt River Project: AA (high investment grade)

Arizona has a bad investment climate for water and wastewater companies

Until we deal with that reality, we will not see meaningful consolidation

- Gold Canyon Sewer Rate Case
- Customers should only pay for the average peak capacity of a system, not the actual peak.
- Global Water's Rate Case
- Utility investors should bear the costs of regional acquisitions.
- Arizona-American - White Tanks Regional water plan
- Cooperative efforts with cities and developers were ignored.

Presented to ACC Water
Workshop Feb 15, 2017

Arizona ROEs

- **10** ACC Decisions for Water and Gas Utilities in 2010
- Average ROE:

9.29%

- Adding 100bp = 10.29
- 10.29% was the ACC's average ROE in 2007.

Presented to ACC Water
Workshop Feb 15, 2007

U.S. ROES

- 115 ROE Decisions nationwide; 97 with Public ROE #s
- 14 Decisions nationwide granted an ROE < 10%
- 9 decisions nationwide within 50 basis points of 9.29% (Arizona's average ROE)
- Only 1 decision nationwide below 9.29%
(AmerenCIPS – Gas in Illinois received 9.19%)

* Public Utilities Reports November 2010 ROE Survey

Presented to ACC Water
Workshop ~~Feb 15, 2011~~
~~Feb 15, 2011~~

U.S. IOU Average ROE in 2010

- From Public Utilities Report, November 2010 Annual ROE Survey
- 115 Cases, 97 publicly available ROEs
- U.S. AVERAGE ROE

10.34%

105bp above Arizona's ROE...

Presented to ACC Water
Workshop Feb 15, 2011

ROE Premium in Arizona

• 9.29% ROE

+

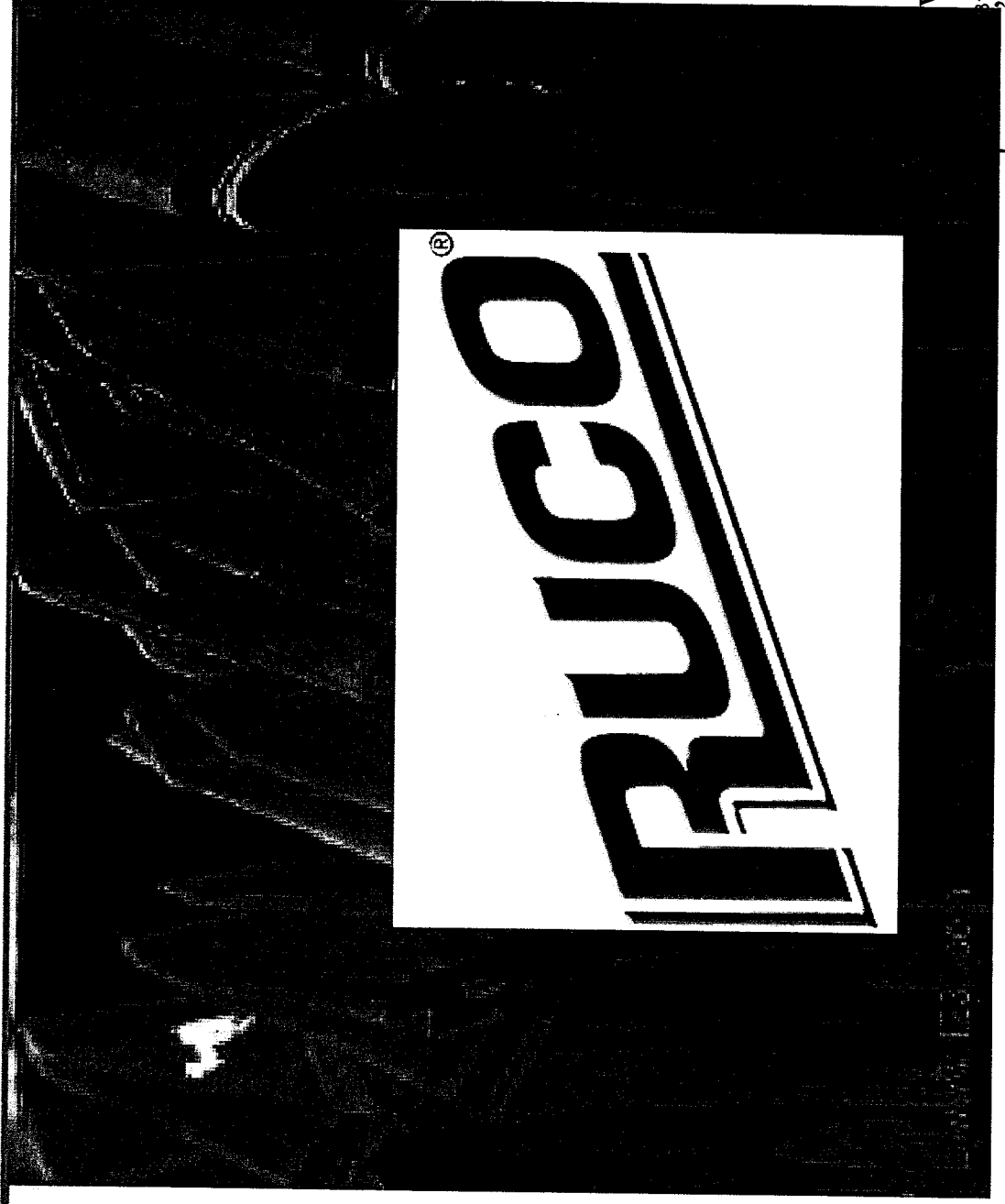
• 100bp Rate Premium

=

10.29 ROE --- Near the U.S. Average

Presented to ACC Water
Workshop Feb 12, 2011

Guess who's coming to the 10.29
discussion?



RUCO®

Water
31/0014

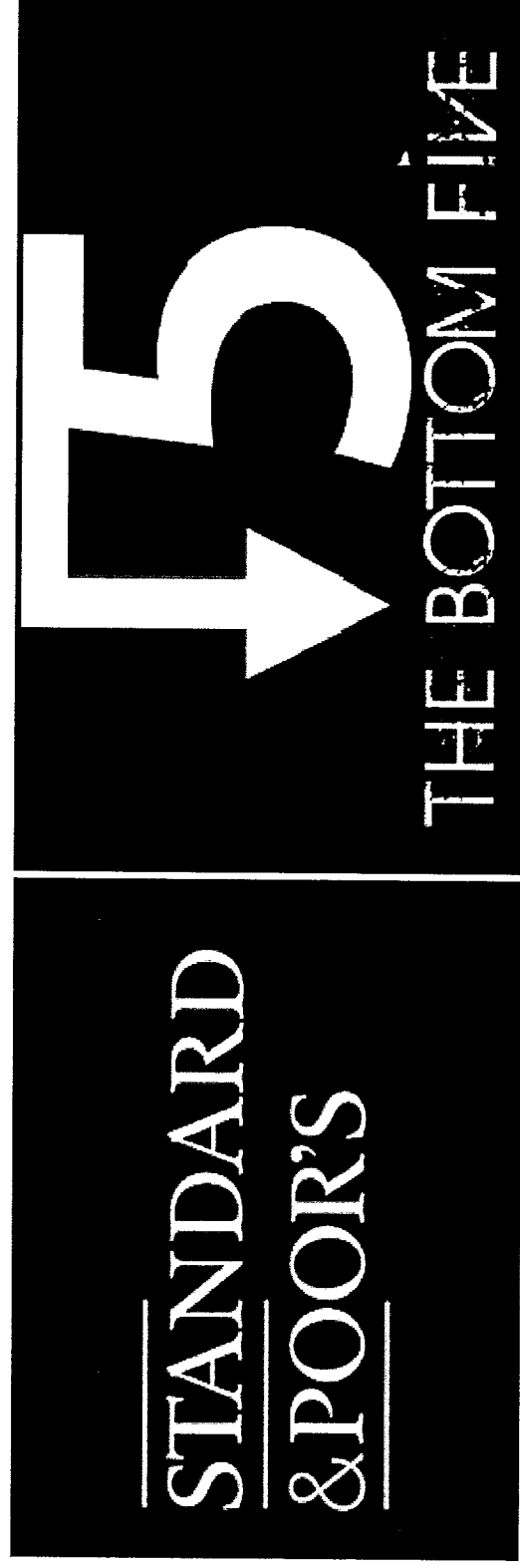
What is the Public Interest?

- RUCO
 - The broad public interest is served by keeping rates as low as possible.
 - [Arizona Republic, "APS argues against free power lines to homebuilders", August 25, 2009]
- Angry Customers' View
 - Rates should be low, period.
- Bonbright View
 - "[S]ound ratemaking policy is a policy of reasonable compromise among partly conflicting objectives."
 - * James Bonbright, Preface, Principles of Public Utility Rates, 1961
- Arizona Constitution
 - The ACC shall balance the needs of shareholders and customers.

Presented to ACC Water
Workshop Feb 23, 2011

Rate Premium – Arizona's Reality

- The ACC provides lower-than-market ROEs and therefore, the rate premium option will not work in Arizona.



Presented to ACC Water
Workshop Feb 12, 2014

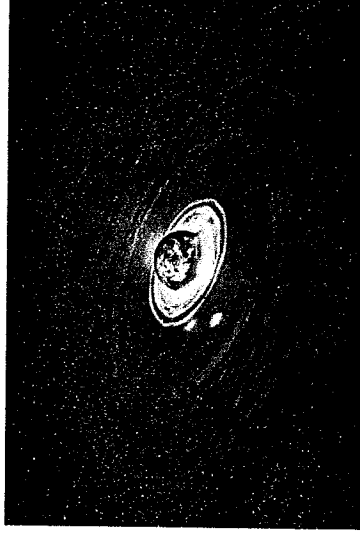
Acquisition Adjustments – Recommended Policy Language

- “Acquisition adjustments are a potentially useful tool that the Arizona Corporation Commission may, in limited circumstances, approve in order to encourage the acquisition of a troubled utility.”

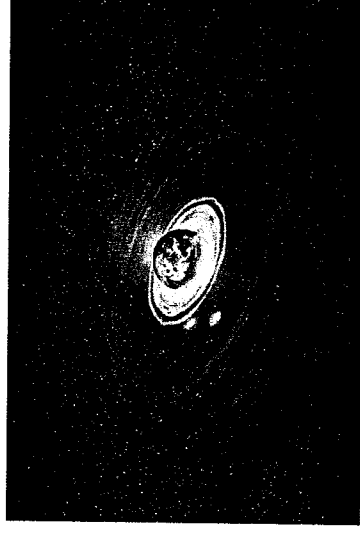
Negative & Nil Rate Bases

- Any number multiplied by 0 = 0.
- Any number multiplied by a negative yields a negative.

10.29% *



=



Presented to ACC Water
Workshop Feb 15, 2009

Negative Rate Base & Acquisition Adjustments

- Trevor Hill Testimony in Global's last rate case:
- Mr. Pierce: So, many [acquired companies] have negative rate base?
 - Mr. Hill: It's true. It's true. Many, many of these companies have negative rate base.
- Mr. Pierce: But [buyers] pay fair market value for them?
 - Mr. Hill: We do.
- Mr. Pierce: So the delta in that is something that would either have to be acquired through an acquisition adjustment or eaten by the shareholders?
- Mr. Hill: Those are your choices.

Summary Points

- Negative & Nil Rate Bases destroy the chance to use Rate Premium or Acquisition Adjustments
- Acquisition Adjustments have never been supported by RUCO.
- Acquisition Adjustments have only been approved in two cases in 20 years – they are not politically practical.
- A Rate Premium in Arizona would only move the ROE to a point near the national average – which is, by definition, not an incentive.



ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-11-0224

DIRECT TESTIMONY

OF

ROBERT B. MEASE

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JUNE 19, 2014

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EXECUTIVE SUMMARY

Arizona Public Service Company ("APS" or "Company") is the largest Class A electric utility and is principal operating subsidiary of Pinnacle West Capital Corporation. APS is an electric utility serving approximately 1.1 million retail customers throughout the state of Arizona. On November 22, 2010, APS filed with the Arizona Corporation Commission ("Commission") an application for authorization to purchase the generating assets from Southern California Edison ("SCE") at the Four Corners Power Plant. In addition, the Company's application requested an accounting order be authorized for the deferral of certain costs associated with the acquisition. On April 24, 2012, by Decision No. 73130, the Commission approved APS request to move forward with the purchase of SCE generating assets and also approved the Company's request for an accounting order authorizing the deferral of certain costs.

On June 1, 2011, APS filed an application requesting an increase in rates and for a determination and approval of a just and reasonable return. On May 24, 2012, by Decision No. 73183, the Commission approved a Settlement Agreement reached by most of the parties in the case. As part of the Settlement Agreement, the parties agreed to leave the docket open until December 31, 2013, for APS to file a request to adjust its rates to reflect the rate base and expense effects associated with the acquisition of SCE's interest in Four Corners Units 4 and 5, the retirement of Units 1, 2 and 3, as well as any cost deferral authorized in the Commission's Decision in the Four Corners Acquisition Docket.

On December 30, 2013, APS purchased SCE's 48 percent share in Units 4 and 5 and now request that the Commission approve a Four Corners rate rider to permit recovery of \$62.52 million annual revenue requirement. (On May 17, 2014, the Company provided updated schedules and their request increased to \$65.43 million) The revenue requirement reflects the cost associated with APS's acquisition of SCE's share of Units 4 and 5, the retirement of Four Corners Units 1, 2 and 3, and for the deferred costs authorized in Decision No. 73130.

While the Company is requesting \$65.43 million in additional revenues RUCO in proposing additional revenues of \$49.20 million.

1 **INTRODUCTION**

2 **Q. Please state your name, position, employer and address.**

3 **A.** My name is Robert Mease and I'm Chief of Accounting and Rates for the Residential
4 Utility Consumers Office. ("RUCO") My business address in 1110 W. Washington
5 Street, Suite 220, Phoenix, AZ.

6
7 **Q. Please state your educational background and qualifications in the utility
8 regulation field.**

9 **A.** Attachment 1, which is attached to this testimony, describes my educational
10 background, work experience and regulatory matters in which I have participated. In
11 summary, I joined RUCO in October of 2011. I graduated from Morris Harvey College in
12 Charleston, WV and attended Kanawha Valley School of Graduate Studies. I am a
13 Certified Public Accountant and currently licensed in the state of West Virginia. My
14 years of work experience include serving as Vice President and Controller of Energy
15 West, Inc. a public utility and energy company located in Great Falls, Montana. While
16 with Energy West I had responsibility for all utility filings and participated in several rate
17 case filings on behalf of the utility. As Energy West was a publicly traded company
18 listed on the NASDAQ Exchange I also had responsibility for all filings with the
19 Securities and Exchange Commission.

20
21 **Q. Please state the purpose of your testimony.**

22 **A.** The purpose of my testimony is to present RUCO's proposals and conclusions
23 regarding the "APPLICATION TO APPROVE FOUR CORNERS RATE RIDER," as filed
24 by APS on December 30, 2013.

1 Douglas Fant
2 3655 W. Anthem Way
3 Suite A – 109, PMB 411
4 Anthem, Arizona 85086

5 Nellis Kennedy-Howard
6 Travis Ritchie
7 Sierra Club Environmental Law Program
8 85 Second St., 2nd Floor
9 San Francisco, California 94105

10 By Cheryl Fraulob
11 Cheryl Fraulob
12
13
14
15
16
17
18
19
20
21
22
23
24

1	John William Moore, Jr. 7321 N. 16 th Street	Nicholas J. Enoch Lubin & Enoch, PC 349 North Fourth Avenue Phoenix, Arizona 85003
2	Phoenix, AZ 85020	
3	Cynthia Zwick 1940 E. Luke Avenue	
4	Phoenix, AZ 85016	Lawrence V. Robertson, Jr. Attorney At Law PO Box 1448 Tubac, Arizona 85646
5	Michael W. Patten Roshka DeWulf & Patten PLC	
6	One Arizona Center 400 E. Van Buren, Suite 800	Laura E. Sanchez NRDC P.O. Box 287 Albuquerque, New Mexico 87103
7	Phoenix, AZ 85004	
8	Bradley Carroll Tucson Electric Power Co.	
9	One South Church Avenue Suite UE201	Jay Moyes Steve Wene Moyes Sellers & Hendricks, Ltd. 1850 N. Central Ave. - 1100 Phoenix, Arizona 85012-2913
10	Tucson, AZ 85701	
11	Jeff Schlegel SWEEP Arizona Representative	
12	1167 W. Samalayuca Drive Tucson, AZ 85704-3224	Jeffrey J. Woner K.R. SALINE & ASSOC., PLC 160 N. Pasadena, Suite 101 Mesa, Arizona 85201
13	Greg Patterson	
14	Munger Chadwick 2398 E. Camelback Road, Suite 240	Scott S. Wakefield Ridenour, Hinton & Lewis, P.L.L.C. 201 N. Central Ave., Suite 3300 Phoenix, Arizona 85004-1052
15	Phoenix, AZ 85016	
16	Michael M. Grant Gallagher & Kennedy, P.A.	
17	2575 E. Camelback Road Phoenix, AZ 85016-9225	Steve W. Chriss Wal-Mart Stores, Inc. 2011 S.E. 10th St. Bentonville, Arkansas 72716-0500
18	Gary Yaquinto, President & CEO	
19	Arizona Investment Council 2100 North Central Avenue, Suite 210	
20	Phoenix, AZ 85004	Craig A. Marks Craig A. Marks, PLC 10645 N. Tatum Blvd. Suite 200-676 Phoenix, Arizona 85028
21	Karen S. White Staff Attorney	
22	Air Force Utility Law Field Support Center	
23	AFLOA/JACL-ULFSC 139 Barnes Drive	Samuel T. Miller USAF Utility Law Field Support Center 139 Barnes Ave., Suite 1 Tyndall AFB, Florida 32403
24	Tyndall AFB, FL 32403	

1 AN ORIGINAL AND THIRTEEN COPIES
2 of the foregoing filed this 19th day
3 of June, 2014 with:

4 Docket Control
5 Arizona Corporation Commission
6 1200 West Washington
7 Phoenix, Arizona 85007

8 COPIES of the foregoing hand delivered/
9 e-mailed or mailed this 19th day of June, 2014 to:

10 Lyn Farmer, Chief Administrative
11 Law Judge
12 Hearing Division
13 Arizona Corporation Commission
14 1200 West Washington
15 Phoenix, Arizona 85007

16 Janice Alward, Chief Counsel
17 Maureen Scott
18 Legal Division
19 Arizona Corporation Commission
20 1200 West Washington
21 Phoenix, Arizona 85007

22 Steven M. Olea, Director
23 Utilities Division
24 Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Meghan H. Gabel
Thomas L. Mumaw
Pinnacle West Capital Corp. Law Dept.
P. O. Box 53999, Mail Station 8695
Phoenix, AZ 85072-3999

Timothy Hogan
Arizona Center for law In
The Public Interest
202 E. McDowell Road, Suite 153
Phoenix, AZ 85004

David Berry
Western Resource Advocates
P. O. Box 1064
Scottsdale, AZ 85252-1064

Barbara Wyllie-Pecora
14410 W. Gunsight Drive
Sun City West, AZ 85375

Michael A. Curtis
William P. Sullivan
Melissa A. Parham
Curtis, Goodwin, Sullivan, Udall &
Schwab, P.L.C.
501 E. Thomas Road
Phoenix, AZ 85012-3205

C. Webb Crockett
Patrick J. Black
Fennemore Craig
3003 N. Central Avenue, Suite 2600
Phoenix, AZ 85012-2913

Kurt J. Boehm
Boehm, Kurtz & Lowry
35 E. 7th Street, Suite 1510
Cincinnati, OH 45202

Jeffrey W. Crockett, Esq.
Brownstein Hyatt Farber Schreck LLP
One East Washington Street, Suite 2400
Phoenix, AZ 85004

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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONER

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY
FOR A HEARING TO DETERMINE THE
FAIR VALUE OF THE UTILITY PROPERTY
OF THE COMPANY FOR RATEMAKING
PURPOSES, TO FIX A JUST AND
REASONABLE RATE OF RETURN
THEREON, AND TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN.

Docket No. E-01345A-11-0224

Arizona Corporation Commission
DOCKETED

JUN 19 2014

DOCKETED BY

ne

NOTICE OF FILING

The RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") provides notice of
filing the Direct Testimony of Robert B. Mease, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 19th day of June, 2014.

Daniel W. Pozefsky
Chief Counsel

ACCOUNTING ORDER

Q. Before we go any further can you explain the purpose of the accounting order as requested by APS?

A. The ACC Staff defines an accounting order as a "rate-making mechanism for use by regulatory authorities that provides regulated utilities the ability to defer costs that would otherwise be expensed using generally accepted accounting principles and provides for alternative rate-making treatment of capital costs and other costs via the creation of regulatory assets and liabilities."¹

Q. Did RUCO agree that an accounting order should be granted in this case?

A. RUCO agreed that the circumstances warranted a variation from the usual ratemaking treatment of plant acquired between rate cases. RUCO disagreed with APS' request to earn a return on the deferred accounts, stating that it would be "simply guaranteeing the Company a return rather than providing it with an opportunity to recover that return via its operating efficiency."

Q. Was the accounting order requested by APS approved by the Commission authorizing the deferral of certain cost(s)?

A. Yes. "Accordingly, we believe an accounting order is appropriate that allows deferral of the non-fuel costs, except that we will include as "non-fuel costs" only the documented debt cost of acquiring SCE's interest in Units 4 and 5, and will not authorize any carrying charges on any deferred costs."²

¹ Decision No. 73130 Page 35 Lines 10 - 14

² Decision No. 73130, Page 37, Lines 7 thru 9

1 **Q. Can you briefly discuss the history of this filing by APS and why the Company is**
2 **applying for an increase in its rates without a general rate case filing?**

3 A. On November 22, 2010 APS filed an application for Commission authorization to
4 purchase the generating assets of Units 4 and 5 of the Four Corners plant owned by
5 Southern California Edison ("SCE") in addition to the approval to close APS Four
6 Corners Units 1, 2 and 3. Also included in the application was APS' request for an
7 accounting order authorizing the deferral of certain costs related to both the purchase of
8 Units 4 and 5 and the closure of Units 1, 2, and 3.

9
10 APS was also required to satisfy the conditions as outlined in Decision No. 67744 that
11 required APS to obtain Commission authorization before APS acquires any unit or
12 interest in a generating unit other than "the acquisition of temporary generation needed
13 for system reliability, distributed generation of less than fifty MW per location, renewable
14 resources, or the up-rating of APS generation" when the in-service date is prior to
15 January 1, 2015.

16
17 On April 24, 2012 Decision No. 73130 was issued by the Arizona Corporation
18 Commission approving both the purchase of the generating assets from SEC, the
19 closure of Units, 1, 2, and 3 and the accounting order authorizing the deferral of the
20 certain costs related to both the purchase and closure transactions. It was also
21 determined during the course of the application review that APS had satisfied the
22 conditions as outlined in Decision No. 67744.

1 **Q. Can you please define what “non-fuel costs” were identified in Decision No. 73130**
2 **that the Commission approved for deferral?**

3 A. The “non-fuel costs” that are authorized for deferral include depreciation, amortization of
4 the acquisition adjustment, decommissioning costs, operations and maintenance costs,
5 property taxes, final coal reclamation costs, the documented debt costs of acquiring
6 SCE’s interest in Units 4 and 5, and miscellaneous other costs. APS estimated that the
7 costs to wind down operations at Units 1 – 3 would be approximately \$20 million and
8 would be incurred between the acquisition date of Units 4 and 5 through 2016.”³
9

10 **Q. Did RUCO agree with APS that the proposed closure of Units 1 – 3 and the**
11 **purchase of Units 4 and 5 was for the benefit of ratepayers and should move**
12 **forward?**

13 A. Yes. RUCO agreed that APS’ analyses showed that the APS transaction saves APS’
14 customers’ money and “has a lower bill impact than that of every likely alternative.
15 RUCO also agreed that APS’ proposed transaction significantly reduces carbon dioxide
16 and other pollutant emissions; “preserves the diversity of APS’ current generation
17 portfolio while tempering the Company’s exposure to volatile natural gas prices,” it
18 maintains the mix of reliable base load energy; and it “saves hundreds of jobs and
19 millions of dollars of revenue that are critical to the Navajo Nation and local economy.”
20
21
22
23
24

³ Decision No. 73130 Page 37 Footnote 122

1 Q. Did APS comply with Decision No. 73130 when submitting this application for
2 recovery of costs related to the purchase of Units 4 and 5?

3 A. No. The Company did not calculate its authorized return on cost deferral's in
4 accordance with Decision No. 73130. The decision specified that only the documented
5 debt cost of acquiring SCE's interest in Units 4 and 5 would be approved, and will not
6 authorize any carrying charges on any deferred costs."⁴
7

8 Q. Can you please explain how APS calculated its rate base and expense
9 adjustments when submitting this application?

10 A. In the Company's filing of this application APS prepared all supporting schedules and
11 calculated all rate base and expense adjustments resulting from the closure of Units 1, 2
12 and 3. The Company also prepared supporting schedules and identified specific
13 adjustments for the purchase of Units 4 and 5. The Company then offset the rate base
14 and expense amounts of Units 1, 2 and 3, that were closed in 2013, against the
15 acquired rate base and projected expenses of Units 4 and 5, going forward, and the net
16 adjustments were then used to increase the rate base that was approved in Decision
17 No. 73183.
18
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⁴ Decision No. 73130, Page 37, Lines 7 thru 9

1 **Q. After the Company made the offsetting rate base and expense adjustments what**
2 **was their next step in calculating the increase in revenues?**

3 A. The Company then carried forward the net adjustments to Schedule EAB-4, Four
4 Corners Revenue Requirement Calculation, and completed the remaining line items to
5 reflect a bottom line increase in revenues of \$65.42.
6

7 **Q. What did the Company use as a rate of return when calculating its final revenue**
8 **increase?**

9 A. The Company calculated its revenue increase at 8.33 percent as was authorized in
10 Decision No. 73183. The authorized rate of return includes both an interest element as
11 well as a return on equity. From RUCO's understanding of Decision No. 73130 only the
12 documented debt cost of acquiring SCE's interest in Units 4 and 5 would be allowed for
13 recovery and not the Company's authorized rate of return which also includes a return
14 on equity.
15

16 **Q. What is the documented cost of debt for the purchase of Units 4 and 5?**

17 A. Per APS's latest filing of amended schedules the documented cost of debt was reduced
18 from 5.25 percent to 4.725 percent.
19

20 **Q. So is RUCO recommending a reduction in the calculation of a rate of return on the**
21 **deferral of costs related to the purchase of Units 4 and 5?**

22 A. Yes. RUCO is proposing a reduction in rate of return of 3.61 percent (8.33 percent less
23 4.725 percent) resulting in a reduction in revenues of approximately \$16.3 million.
24

1 **ACQUISITION ADJUSTMENT**

2 **Q. Mr. Mease, did the Company request an "acquisition adjustment" in its request for**
3 **a change in rates resulting from this transaction?**

4 **A.** Yes. An acquisition adjustment was requested in APS's original filing seeking approval
5 to move forward with the acquisition on Units 4 and 5. The acquisition adjustment was
6 approved by the Commission in Decision No. 10-0327. The Company's increase in rate
7 base of \$225.9 million is primarily related to the acquisition premium that APS is
8 requesting.

9
10 **Q. Can you please provide a definition of an acquisition adjustment?**

11 **A.** An acquisition adjustment is "The difference between the price an acquiring company
12 pays to purchase a target company and the net original cost of the target utility
13 company's assets. An acquisition adjustment is the premium paid for acquiring a
14 company more than its tangible assets or book value."

15
16 **Q. Does the Commission have a specific policy addressing an acquisition**
17 **adjustment when a utility company pays in excess of book value for another**
18 **utility's assets?**

19 **A.** There is no specific policy that I'm aware but there is a statement included in Staff's
20 Data Request No. 39.3 to APS that reads as follows, "Staff's understanding of the
21 general rule in Arizona is that the Commission does not permit recovery of an
22 acquisition adjustment arising from the sale of assets barring extraordinary
23 circumstances."

24

1 **Q. Also in Data Request No. 39.3 APS was ask to explain what extraordinary**
2 **circumstances exist that would justify the Commission's recognition of an**
3 **acquisition adjustment in this case? What was APS response to this request?**

4 **A. APS responded as follows:**

5 Decision No. 73130 (April 24, 2012) established the Four Corners acquisition
6 from SCE as an extraordinary circumstance that warranted both an exemption
7 from the "self-built" moratorium imposed by the Commission in Decision No
8 67744 (April 5, 2005) and the "best practices" for resource acquisition later
9 codified in the Commission's Resource Planning Rules. See A.A.C. R14-2-
10 702(B) (5).

11 The acquisition was also extraordinary in the level of customer benefit (over \$400
12 million on a net present value basis), the ability to preserve APS's customers'
13 existing benefits from the Company's pre-existing share of Four Corners 4 and 5,
14 and the significant environmental benefit (specifically cited in Decision No. 73130
15 at pages 8 – 11) from the closure of Units 1 – 3 by the end of 2013. None of
16 these benefits would have happened absent this transaction.

17 **Q. Mr. Mease, I have one more question related to Staff Data Request No. 39.3. Part**
18 **(b) of the request ask APS to please explain how this transaction would not likely**
19 **have occurred without the acquisition adjustment. What was APS response to**
20 **this request?**

21 **A. APS response to (b) as follows:**

22 The transaction could never have occurred absent the agreement by APS to pay
23 a sufficient amount to compensate SCE for its exit of the facility prior to mid-2016.
24 SCE would not have agreed to a selling price that placed it in a worse economic
position than not selling, and even if SCE would have agreed to a contract that
was financially irresponsible, the sale would never have received the necessary
CPUC approval.

And neither APS nor any other rational utility would agree to pay nearly \$300
million for a plant and then write off five sixths of that investment less than a year
later. The significant operational benefits from additional ownership of Four
Corners 4 and 5 justifying APS' acquisition would all accrue to APS customers,
leaving APS shareholders with nothing to show for management's good faith
efforts to benefit customers but a staggering write off.

1 Q. **Based on the response by APS to part (b) of this request, does it appear that APS**
2 **was certain in its answer that they, APS, would get approval to include an**
3 **acquisition adjustment, otherwise, the purchase would not have occurred?**

4 A. Yes. By their response above I believe it's safe to make that assumption. However, as
5 stated in the Conclusions of Law, Page 43, of Decision No. 73130, "IT IS FURTHER
6 ORDERED that Arizona Public Service Company is authorized to defer for possible later
7 recovery through rates, all non-fuel costs (as defined herein) of owning, operating, and
8 maintaining the acquired Southern California Edison interest in Four Corners Units 4
9 and 5 and associated facilities. Nothing in this Decision shall be construed in any way
10 to limit the Commission's authority to review the entirety of the acquisition and to make
11 any disallowances thereof due to imprudence, errors or inappropriate application of the
12 requirements of this Decision.

13
14 Q. **Has anything come to your attention that would make you question APS's belief**
15 **that the acquisition adjustment that they are requesting could be disallowed by**
16 **the Commission?**

17 A. Yes. When reviewing Pinnacle West Capital Corporation Notes to Consolidated
18 Financial Statement, for the period ending December 31, 2013, page 100, discussing
19 the Four Corners transaction we noted the following, "While we expect the ACC to
20 approve the recovery of the acquisition adjustment, should recovery be disallowed, it will
21 be reclassified from plant-in-service to goodwill subject to impairment testing."

1 In addition, in Mr. Guldner's direct testimony in the original filing for the approval to
2 move forward with the purchase of Units 4 and 5, he states

3 "And I guess it's my opinion that you clearly can argue about
4 how you measure the return component. And for example, in
5 the Palo Verde Unit 3 order, the return component that was
6 authorized in that case was a debt-only return. And I think
7 that's actually what the Company ask for was rather than have
8 the three components of debt, equity and the tax gross-up, in
9 that case the debt expense was deferred as the return
10 component. And so I think it's fair to argue how you calculate
11 that return component."

12
13 **Q. What is APS requesting as an acquisition adjustment in this application?**

14 **A.** After making all the accounting entries related to the purchase of SCE's interest in the
15 Four Corners generating facilities Units 4 and 5 the Company is requesting an
16 adjustment of \$243.9 million.

17
18 **Q. Does RUCO believe that there are specific risks, either operational or financial,
19 associated with the purchase of Units 4 and 5?**

20 **A.** Certainly there are risks involved in any business transaction of this magnitude but more
21 specifically the relevant environmental risks associated with the Company's investment
22 in coal operated facilities. These risks are generally well known and were discussed at
23 length between the time the Company filed its application for the approval of the
24 transaction and the final Decision authorizing the Company to move forward. While the
purchase transaction as presented in the original application filed with, and agreed to,
by the Commission in Decision No. 73130 was authorized to move forward the inherent
risks remain the same or have compounded since the Company filed its original
application for authorization to move forward.

1 Q. Can you discuss several of the risks that you are referring to in you previous
2 answer?

3 A. Yes. As the Company stated in their response to RUCO Data Responses to Nos. 2.6
4 and 2.7, when asked. "Has APS identified and attempted to quantify potential risks from
5 further EPA rulings that may impact the economics of Four Corners?

6 Yes. As explained in their response RUCO DR 2.6, "The potential risks from
7 further EPA rulings were identified in APS's 2014 Integrated Resource Plan
8 ("IRP") – Chapter 3 & Section E. As further identified in their response to DR. 2.7
9 the Company responded as follows:

10 Uncertainty pertaining to regional haze regulations (BART) – APS has assumed
11 and included the installation costs of SCR controls in the analysis.

12 Uncertainty pertaining to National Ambient Air Quality Standard (NAAQS) –
13 Because the proposed ozone NAAQS were withdrawn by EPA and the agency
14 has yet to establish new NAAQS for ozone, it is difficult to estimate the impact, if
15 any, of new standards on the Four Corners evaluation.

16 Uncertainties pertaining to RCRA regulations – Proposed regulations include two
17 different scenarios – Subtitle C (hazardous) and Subtitle D (non-hazardous). For
18 the Four Corners evaluation and all other studies, APS has assumed EPA will
19 choose to regulate CCR under Subtitle D and has included cost estimates in the
20 analyses. The Subtitle C option was not evaluated because APS does not believe
21 CCRs to be hazardous waste, but APS estimates the CCR costs would be 20%
22 higher than Subtitle C.

23 Uncertainty pertaining to Greenhouse gas (GHG) - New source performance
24 standards (NSPS) regulations – APS has included in its analysis the potential for
carbon pricing in the form of three carbon price forecasts, see response to Staff
35.31 and 35.35

Uncertainty pertaining to Effluent limitation guidelines (ELG) – Any revisions to
the ELG would impact the discharge limits at Four Corners which may be faced
with increased capital and O&M expenses to achieve and maintain compliance.
This risk was not evaluated because the EPA is not expected to have a final rule
until late 2015 and it is uncertain what, if any, impact will come from such
regulation.

1 **Q. Do you believe that the Company shareholders should share in the risks**
2 **associated with the purchase of Units 4 and 5?**

3 A. Yes. Other than the general business risks that are associated with any merger or
4 acquisition, there are additional risks as identified above. The ratepayer should not
5 have to bear the burden of assuming all risks in this transaction. By the Commission's
6 authorizing for recovery in rates only the documented debt cost of acquiring SCE's
7 interest in Units 4 and 5, the Commission recognizes that there is an inherent risk that
8 should be shared between the ratepayer and Company shareholders.
9

10 **Q. Is RUCO recommending that APS recover its acquisition costs?**

11 A. Yes. RUCO did not take exception to an acquisition adjustment in APS original filing
12 requesting Commission authorization to move forward with the purchase of Units 4 and
13 5 and has not changed its position in this filing. Decision No. 73130, shares the risk of
14 this transaction between the Company and ratepayers, so RUCO continues to support
15 the acquisition adjustment as was authorized in that decision.
16

17 **Q. Does RUCO believe that the Commission will be establishing a policy on**
18 **acquisition premiums based on its Decision No. 73130?**

19 A. RUCO's position is that the Commission should approve the acquisition adjustment
20 because the transaction is in the public interest and without it there may not have be a
21 transaction. RUCO believes that in most cases an acquisition adjustment is unwarranted
22 and such a policy favoring a premium on its face value would provide little motivation for
23 a Company not to overpay. That is not an issue in this case.
24

RUCO'S RECOMMENDATIONS

Q. Can you please summarize what RUCO is recommending in this application?

A. RUCO is proposing a reduction in revenue requirements as requested by APS from \$65.43 million to \$49.20 million. The reduction of \$16.23 million is due to APS's requesting a rate of return on rate base adjustments of 8.33 percent while RUCO is proposing that the return on the adjusted rate base of 4.725 percent.

APS Requested Revenue Increase	\$ 65,436
--------------------------------	-----------

RUCO's Recommended Revenue Increase	<u>\$ 49,198</u>
-------------------------------------	------------------

RUCO's Recommended Reduction in Revenues	<u>\$ 16,238</u>
--	------------------

(See Attachment 2)

RATE DESIGN

Q. Has RUCO update the rate design schedules, as were filed by the Company, based on its recommended increase in revenues?

A. Yes. See Attachment 3. Rates have been established using the same methodology as requested by APS. The percentage increase is being applied as an equal percentage to the base rate portion of customers' bills as was agreed to in the Settlement Agreement. The average monthly bill for APS residential customers will increase by approximately \$2.17, representing a 1.5 percent increase in their monthly billing. (See Attachment 3)

Q. Mr. Mease, does this conclude your testimony?

A. Yes.

ATTACHMENT 1

ROBERT B. MEASE, CPA Education and Professional Qualifications

EDUCATION

Bachelors Degree Business Administration / Accounting - Morris Harvey College.

Attended West Virginia School of Graduate Studies and studied Accounting and Public Administration

Attended numerous courses and seminars for Continuing Professional Educational purposes.

WORK EXPERIENCE

Controller

Knives of Alaska, Inc., Diamond Blade, LLC, and Alaska Expedition Company.

Financial Manager / CFO

All Saints Camp & Conference Center

Energy West, Inc.

Vice President, Controller

- Led team that succeeded in obtaining a \$1.5 million annual utility rate increase
- Coached accountants for proper communication techniques with Public Service Commission, supervised 9 professional accountants
- Developed financial models used to negotiate an \$18 million credit line
- Responsible for monthly, quarterly and annual financial statements for internal and external purposes, SEC filings on a quarterly and annual basis, quarterly presentations to Board of Directors and shareholders during annual meetings, coordinated annual audit
- Communication with senior management team, supervised accounting staff and resolved all accounting issues, reviewed expenditures related to capital projects
- Monitored natural gas prices and worked with senior buyers to ensure optimal price obtained

Junkermier, Clark, Campanella, Stevens

Consulting Staff

- Established a consulting practice that generated approximately \$160k the first year of existence
- Prepared business plan and projections for inclusion in clients financing documents
- Prepared written reports related to consulting engagements performed
- Developed models used in financing documents and made available for other personnel to use
- Performed Profit Enhancement engagements
- Participated during audit of large manufacturing client for two reporting years

Prior to 1999, held various positions: TMC Sales, Inc. as **Vice President / Controller**, with American Agri-Technology Corporation as **Vice President / CFO** and with Union Carbide Corporation as **Accounting Manager**. (Union Carbide was a multi-national Fortune 500 Company that was purchased by Dow Chemical)

PROFESSIONAL AFFILIATIONS

Member - Institute of Management Accountants

Member - American Institute of CPA's

Member – Society of Utility and Regulatory Financial Analysts

Past Member –WV Society of CPA's and Montana Society of CPA's

RESUME OF RATE CASE AND REGULATORY PARTICIPATION WITH RUCO

<u>Utility Company</u>	<u>Docket No.</u>
Arizona Water Company (Eastern Group)	W-01445A-11-0310
Pima Utility Company	W-02199A-11-0329 et al.
Tucson Electric Power Company	E-01933A-12-0291
Arizona Water Company (Northern Group)	W-01445A-12-0348
UNS Electric	E-04204A-12-0504
Global Water	W-01212A-12-0309 et al.
LPSCO	SW-01428A-13-0042 et al.
Johnson Utilities	WS-02987A-13-0477

REVENUE REQUIREMENT - REVISED
ACC JURISDICTIONAL - AS SUBMITTED BY COMPANY
(Thousands of Dollars)

LINE NO.	DESCRIPTION	ORIGINAL SETTLEMENT		(D) PRO FORMA ADJUSTMENTS	ADJUSTED SETTLEMENT WITH ACQUISITION		
		(A) COMPANY ORIGINAL COST	(B) COMPANY RCND		(E) RUCO ORIGINAL COST	(F) RUCO RCND	(G) RUCO FAIR VALUE
1	Adjusted Rate Base	\$ 5,682,998	\$ 10,671,253	\$ 8,167,126	\$ 5,888,932	\$ 10,897,187	\$ 8,393,060
2							
3	Adjusted Operating Income (Loss)	\$ 496,769	\$ 496,769	\$ 496,769	\$ 476,089	\$ 476,089	\$ 476,089
4							
5	Fair Value Adjustment Embedded in Operating Income	25,041	25,041	25,041	25,041	25,041	25,041
6							
7	Adjusted Operating Income (Ln 3 - Ln 5)	471,728	471,728	471,728	451,048	451,048	451,048
8							
9	Current Rate of Return (Ln 7 / Ln 1)	8.33%	4.42%	5.78%	7.66%	4.14%	5.37%
10							
11	Required Operating Income (Ln 1 x Ln 13)	\$ 471,728	\$ 471,728	\$ 471,728	\$ 490,548	\$ 490,548	\$ 490,548
12							
13	Required Rate of Return	8.33%	4.42%	5.78%	8.33%	4.50%	5.84%
14							
15	Adjusted Operating Income Deficiency	-	-	-	\$ 39,500	\$ 39,500	\$ 39,500
16							
17	Gross Revenue Conversion Factor	1.6566	1.6566	1.6566	1.6566	1.6566	1.6566
18							
19	Requested Increase in Revenue Requirement (Ln 15 X Ln 17)	\$ -	\$ -	\$ -	\$ 65,436	\$ 65,436	\$ 65,436

Source of Schedule - Submitted by Company as Attachment EAB-4
(Revised on May 17, 2014 in Staff Data Request)

Attachment 2

COMPARISON OF REVENUE REQUIREMENTS - RUCO'S RECOMMENDATION

(Thousands of Dollars)

Line No		(A)	(B)	(C)		(D)		(E)		(F)	
		TOTAL COMPANY	ACC JURISDICTION	WGT AVG COST OF CAPITAL	DEBT RATE	WGT AVG COST OF CAPITAL	DEBT RATE	ACC JURISDICTION	DEBT RATE		
FOUR CORNERS REVENUE REQUIREMENTS											
1	Four Corners Acquisition Units 4 and 5	\$	55,670	\$	53,777	\$	55,670	\$	53,777	\$	53,777
2	Four Corners Acquisition Adjustment		252,510		243,925		252,510		243,925		243,925
3	Four Corners Acquisition (Decommissioning Lia.)		(34,123)		(32,963)		(34,123)		(32,963)		(32,963)
4	Four Corners Acquisition (Coal Reclamation Lia.))		(92,951)		(89,791)		(92,951)		(89,791)		(89,791)
5	Four Corners Auxiliary Plant		11,065		10,689		11,065		10,689		10,689
6	Four Corners Deferred Costs Units 1, 2 and 3		41,716		40,298		41,716		40,298		40,298
7			233,887		225,935		233,887		225,935		225,935
8											
9	Settlement Pre-Tax Weighted Avg Cost of Capital		11.856%		11.856%		4.725%		11.856%		4.725%
10											
11	Return on Rate Base (with Rev. Conversion Factor Adj)		27,861		26,913		27,730		26,913		10,675
12											
EXPENSE ADJUSTMENTS											
13											
14	Incremental O&M Expense Related to Acquisition		5,601		5,411		5,601		5,411		5,411
15	Incremental Property Tax & Other Taxes		6,419		6,201		6,419		6,201		6,201
16	Incremental Depreciation Expense		2,671		2,580		2,671		2,580		2,580
17	Amortization of Four Corners Acquisition Adj.		10,707		10,343		10,707		10,343		10,343
18	Amortization of Four Corners Deferral Balance (10 Years)		6,896		6,662		6,896		6,662		6,662
19	Final Coal Reclamation on Acquired Portion		4,499		4,346		4,499		4,346		4,346
20	Decommissioning on Acquired Portion		3,085		2,980		3,085		2,980		2,980
21			39,878		38,523		39,878		38,523		38,523
22											
23	TOTAL REVENUE REQUIREMENT	\$	67,739	\$	65,436	\$	67,608	\$	65,436	\$	49,198

Source of Schedule - Prepared from Data Responses provided by APS
and RUCO workpapers

Attachment 3

Four Corners Rate Rider
Estimated Bill Impacts

Schedule RBM-3

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Residential (Average - All Rates)						
Average kWh per Month	1,100	1,100	1,337	1,337	863	863
Base Rates	\$ 123.90	\$ 123.90	\$ 161.07	\$ 161.07	\$ 86.72	\$ 86.72
Four Corners Adjustment	\$ -	\$ 2.17	\$ -	\$ 2.82	\$ -	\$ 1.52
PSA - Forward Component	\$ 1.41	\$ 1.41	\$ 1.71	\$ 1.71	\$ 1.10	\$ 1.10
PSA - Historical Component	\$ 0.31	\$ 0.31	\$ 0.37	\$ 0.37	\$ 0.24	\$ 0.24
TCA	\$ 7.12	\$ 7.12	\$ 8.65	\$ 8.65	\$ 5.58	\$ 5.58
RES	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11
DSMAC	\$ 2.99	\$ 2.99	\$ 3.63	\$ 3.63	\$ 2.34	\$ 2.34
LFCR	\$ 0.28	\$ 0.29	\$ 0.36	\$ 0.37	\$ 0.20	\$ 0.20
TOTAL	\$ 140.12	\$ 142.30	\$ 179.90	\$ 182.73	\$ 100.29	\$ 101.81
Bill Impact		\$ 2.18 1.55%		\$ 2.83 1.57%		\$ 1.52 1.51%

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Residential (Average - All Rates)						
Average kWh per Month	691	691	780	780	602	602
Base Rates	\$ 86.40	\$ 86.40	\$ 108.04	\$ 108.04	\$ 64.76	\$ 64.76
Four Corners Adjustment	\$ -	\$ 1.51	\$ -	\$ 1.89	\$ -	\$ 1.13
PSA - Forward Component	\$ 0.89	\$ 0.89	\$ 1.00	\$ 1.00	\$ 0.77	\$ 0.77
PSA - Historical Component	\$ 0.20	\$ 0.20	\$ 0.22	\$ 0.22	\$ 0.17	\$ 0.17
TCA	\$ 4.48	\$ 4.48	\$ 5.05	\$ 5.05	\$ 3.90	\$ 3.90
RES	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11	\$ 4.11
DSMAC	\$ 1.88	\$ 1.88	\$ 2.12	\$ 2.12	\$ 1.64	\$ 1.64
LFCR	\$ 0.20	\$ 0.20	\$ 0.24	\$ 0.25	\$ 0.15	\$ 0.15
TOTAL	\$ 98.16	\$ 99.67	\$ 120.78	\$ 122.68	\$ 75.50	\$ 76.63
Bill Impact		\$ 1.51 1.54%		\$ 1.90 1.57%		\$ 1.13 1.50%

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Residential (Rates E-12, 0-20kW)						
Average kWh per Month	1,430	1,430	1,575	1,575	1,285	1,285
Base Rates	\$ 202.30	\$ 202.30	\$ 232.85	\$ 232.85	\$ 171.75	\$ 171.75
Four Corners Adjustment	\$ -	\$ 3.54	\$ -	\$ 4.08	\$ -	\$ 3.01
PSA - Forward Component	\$ 1.83	\$ 1.83	\$ 2.01	\$ 2.01	\$ 1.64	\$ 1.64
PSA - Historical Component	\$ 0.40	\$ 0.40	\$ 0.44	\$ 0.44	\$ 0.36	\$ 0.36
TCA	\$ 3.58	\$ 3.58	\$ 3.94	\$ 3.94	\$ 3.22	\$ 3.22
RES	\$ 14.68	\$ 14.68	\$ 16.17	\$ 16.17	\$ 13.19	\$ 13.19
DSMAC	\$ 3.89	\$ 3.89	\$ 4.28	\$ 4.28	\$ 3.49	\$ 3.49
LFCR	\$ 0.45	\$ 0.46	\$ 0.52	\$ 0.53	\$ 0.39	\$ 0.39
TOTAL	\$ 227.13	\$ 230.68	\$ 260.21	\$ 264.30	\$ 194.04	\$ 197.05
Bill Impact		\$ 3.55 1.56%		\$ 4.09 1.57%		\$ 3.01 1.55%

Arizona Public Service Corporation
Docket No. E-01345A-11-0224
Test Year Ended December 31, 2010

Four Corners Rate Rider
Estimated Bill Impacts

Schedule RBM-3

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Commercial (Rate E-32, >20 kW)						
Average kWh per Month	62,238	62,238	68,381	68,381	56,094	56,094
Base Rates	\$ 5,977.26	\$ 5,977.26	\$ 7,044.20	\$ 7,044.20	\$ 4,910.31	\$ 4,910.31
Four Corners Adjustment	\$ -	\$ 104.62	\$ -	\$ 123.29	\$ -	\$ 85.94
PSA - Forward Component	\$ 79.48	\$ 79.48	\$ 87.32	\$ 87.32	\$ 71.63	\$ 71.63
PSA - Historical Component	\$ 17.43	\$ 17.43	\$ 19.15	\$ 19.15	\$ 15.71	\$ 15.71
TCA	\$ 165.94	\$ 165.94	\$ 177.69	\$ 177.69	\$ 154.18	\$ 154.18
RES	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49
DSMAC	\$ 189.52	\$ 189.52	\$ 202.94	\$ 202.94	\$ 176.09	\$ 176.09
LFCR	\$ 13.16	\$ 13.43	\$ 15.37	\$ 15.68	\$ 10.96	\$ 11.18
TOTAL	\$ 6,595.28	\$ 6,700.17	\$ 7,699.16	\$ 7,822.76	\$ 5,491.37	\$ 5,577.53
Bill Impact		\$ 104.89 1.59%		\$ 123.60 1.61%		\$ 86.16 1.57%

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Commercial (Rate E-32 M)						
Average kWh per Month	62,238	62,238	68,381	68,381	56,094	56,094
Base Rates	\$ 6,431.49	\$ 6,431.49	\$ 7,407.75	\$ 7,407.75	\$ 5,455.22	\$ 5,455.22
Four Corners Adjustment	\$ -	\$ 112.57	\$ -	\$ 129.66	\$ -	\$ 95.48
PSA - Forward Component	\$ 79.48	\$ 79.48	\$ 87.32	\$ 87.32	\$ 71.63	\$ 71.63
PSA - Historical Component	\$ 17.43	\$ 17.43	\$ 19.15	\$ 19.15	\$ 15.71	\$ 15.71
TCA	\$ 165.94	\$ 165.94	\$ 177.69	\$ 177.69	\$ 154.18	\$ 154.18
RES	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49
DSMAC	\$ 189.52	\$ 189.52	\$ 202.94	\$ 202.94	\$ 176.09	\$ 176.09
LFCR	\$ 14.07	\$ 14.36	\$ 16.09	\$ 16.42	\$ 12.05	\$ 12.29
TOTAL	\$ 7,050.42	\$ 7,163.28	\$ 8,063.43	\$ 8,193.42	\$ 6,037.37	\$ 6,133.09
Bill Impact		\$ 112.86 1.60%		\$ 129.99 1.61%		\$ 95.72 1.59%

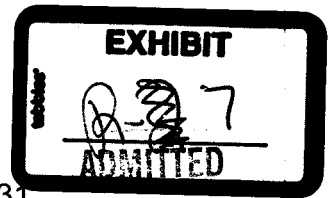
	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
Residential (Rates E-12, 0-20kW)						
Average kWh per Month	290,507	290,507	314,925	314,925	266,089	266,089
Base Rates	\$ 24,709.54	\$ 24,709.54	\$ 29,456.69	\$ 29,456.69	\$ 19,962.38	\$ 19,962.38
Four Corners Adjustment	\$ -	\$ 432.48	\$ -	\$ 515.57	\$ -	\$ 349.39
PSA - Forward Component	\$ 370.96	\$ 370.96	\$ 402.16	\$ 402.16	\$ 339.80	\$ 339.80
PSA - Historical Component	\$ 81.34	\$ 81.34	\$ 88.18	\$ 88.18	\$ 74.50	\$ 74.50
TCA	\$ 607.71	\$ 607.71	\$ 674.34	\$ 674.34	\$ 541.08	\$ 541.08
RES	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49	\$ 152.49
DSMAC	\$ 694.07	\$ 694.07	\$ 770.16	\$ 770.16	\$ 617.97	\$ 617.97
TOTAL	\$ 26,616.11	\$ 27,048.59	\$ 31,544.02	\$ 32,059.59	\$ 21,688.22	\$ 22,037.61
Bill Impact		\$ 432.48 1.62%		\$ 515.57 1.63%		\$ 349.39 1.61%

Arizona Public Service Corporation
Docket No. E-01345A-11-0224
Test Year Ended December 31, 2010

Four Corners Rate Rider
Estimated Bill Impacts

Schedule RBM-3

	Current	Requested Jul-14	Current	Requested Jul-14	Current	Requested Jul-14
	Annual Average Monthly Bills	Annual Average Monthly Bills	Summer Monthly Bill	Summer Monthly Bill	Winter Monthly Bill	Winter Monthly Bill
<i>Industrial (Rate E34 / E35)</i>						
Average kWh per Month	3,581,412	3,581,412	3,729,201	3,729,201	3,433,622	3,433,622
Base Rates	\$ 249,125.86	\$ 249,125.86	\$ 259,882.57	\$ 259,882.57	\$ 238,369.15	\$ 238,369.15
Four Corners Adjustment	\$ -	\$ 4,360.36	\$ -	\$ 4,548.63	\$ -	\$ 4,172.09
PSA - Forward Component	\$ 4,573.47	\$ 4,573.47	\$ 4,762.19	\$ 4,762.19	\$ 4,384.74	\$ 4,384.74
PSA - Historical Component	\$ 1,002.80	\$ 1,002.80	\$ 1,044.18	\$ 1,044.18	\$ 961.41	\$ 961.41
TCA	\$ 8,618.22	\$ 8,618.22	\$ 9,090.63	\$ 9,090.63	\$ 8,145.81	\$ 8,145.81
RES	\$ 3,335.00	\$ 3,335.00	\$ 3,335.00	\$ 3,335.00	\$ 3,335.00	\$ 3,335.00
DSMAC	\$ 6,395.98	\$ 6,395.98	\$ 6,746.57	\$ 6,746.57	\$ 6,045.38	\$ 6,045.38
LFCR						
TOTAL	\$ 273,051.33	\$ 277,411.69	\$ 284,861.14	\$ 289,409.77	\$ 261,241.49	\$ 265,413.58
Bill Impact		\$ 4,360.36 1.60%		\$ 4,548.63 1.60%		\$ 4,172.09 1.60%



EPCOR WATER ARIZONA, INC.

DOCKET NOS. W-01732A-15-0131 and W-01303A-15-0131

DIRECT TESTIMONY

OF

JEFFREY M. MICHLIK

ON BEHALF OF THE

RESIDENTIAL UTILITY CONSUMER OFFICE

OCTOBER 9, 2015

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ATTACHMENTS

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RUCO Data Requests and Company Responses.....	Attachment B
Staff and Commission Policy.....	Attachment C
News Paper Articles.....	Attachment D
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NAWC – Acquisition Adjustments by States.....	Attachment F

EXECUTIVE SUMMARY

On April 22, 2015 Willow Valley Water Co., Inc. ("Willow Valley") and EPCOR Water Arizona Inc. ("EWAZ") filed an application with the Arizona Corporation Commission ("Commission") requesting the sale of Willow Valley's utility system and transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ.

On June 1, 2015 EWAZ made a supplemental filing seeking approval of recovery of price paid in excess of rate base, in other words an acquisition premium to be paid by ratepayers in the future.

The direct testimony of Jeffrey M. Michlik is limited to the Acquisition Premium and the Accumulated Deferred Income Tax ("ADIT").

RUCO recommends that no acquisition premium be authorized by the Commission in this case, simply because there are no benefit(s) to ratepayers in this case.

The acquisition premium methodology as proposed in this case is similar to a SIB and may be illegal. (i.e. An increase in rates between rate cases without a fair value determination)

RUCO recommends that ratepayers be held harmless ^{of the effects of} ~~and that the ADIT balance of \$260,224 also be transferred to EWAZ, and reclassified as a regulatory liability for ratemaking purposes, which is just good public policy.~~
(see Surrebuttal Testimony of Ralph C. Smith)

I. INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is Jeffrey M. Michlik. I am a Public Utilities Analyst V employed by the Arizona Residential Utility Consumer Office ("RUCO"). My business address is 1110 West Washington Street, Suite 220, Phoenix, Arizona 85007.

Q. Briefly describe your responsibilities as a Public Utilities Analyst V.

A. In my capacity as a Public Utilities Analyst V, I analyze and examine accounting, financial, statistical and other information and prepare reports based on my analyses that present RUCO's recommendations to the Arizona Corporation Commission ("Commission") on utility revenue requirements, rate design and other matters. I also provide expert testimony on these same issues.

Q. Please describe your educational background and professional experience.

A. In 2000, I graduated from Idaho State University, receiving a Bachelor of Business Administration Degree in Accounting and Finance, and I am a Certified Public Accountant with the Arizona State Board of Accountancy. I have attended the National Association of Regulatory Utility Commissioners' ("NARUC") Utility Rate School, which presents for study

1 and review general regulatory and business issues. I have also attended
2 various other NARUC sponsored events.

3
4 I joined RUCO as a Public Utilities Analyst V in September of 2013. Prior to
5 my employment with RUCO, I worked for the Arizona Corporation
6 Commission in the Utilities Division as a Public Utilities Analyst for a little
7 over seven years. Prior to employment with the Commission, I worked one
8 year in public accounting as a Senior Auditor, and four years for the Arizona
9 Office of the Auditor General as a Staff Auditor.

10
11 **Q. What is the scope of your testimony in this case?**

12 A. I am presenting RUCO's analysis of EWAZ's proposed acquisition premium
13 and the Accumulated Deferred Income Tax ("ADIT") issue, and not the sale
14 of Willow Valley's assets or the transfer of the CC&N to EWAZ.

15
16 **II. BACKGROUND**

17 **Q. Please review the background of this application.**

18 A. EPCOR Water Arizona Inc. ("EWAZ" or "Company") is an Arizona "C"
19 Corporation.¹ EPCOR is a for profit, certificated Arizona public service
20 corporation that provides water and wastewater utility service to various
21 communities throughout the State of Arizona. Global Water Resources Inc.

¹ On February 1, 2012, EPCOR Water (USA) Inc. ("EWUS") acquired all of Arizona American Water Company's District in Arizona and in New Mexico.

1 ("Global") is also an Arizona "C" Corporation, and is also a for profit, Arizona
2 public service corporation that provides water and wastewater utility
3 services to various communities throughout Arizona. On April 22, 2015,
4 EWAZ and Global filed a joint application requesting Commission
5 authorization for the sale and transfer of its Certificate of Convenience and
6 Necessity ("CC&N") from Global to EWAZ. In the initial application EWAZ
7 also asked for an acquisition adjustment, and on June 1, 2015 filed a
8 supplemental application describing how the acquisition adjustment
9 mechanism would work. EWAZ's corporate business office is located at
10 2355 W. Pinnacle Peak Road, Suite 300 Phoenix, Arizona 85027. Global's
11 corporate business office is located at 21410 North 14th Avenue Suite 201,
12 Phoenix, Arizona 85027. Both companies are classified as class A utility
13 companies.

14
15 Willow Valley is an Arizona Corporation that provides water utility service to
16 approximately 1,620 customers in portions of Mohave County. Willow
17 Valley received its CC&N pursuant to Decision No. 32436 (August 23,
18 1960). Willow Valley is a subsidiary of Global.

19
20 **III. EWAZ'S AND GLOBAL'S CORPORATE STRUCTURE**

21 **Q. Can you provide additional background on EWAZ's corporate**
22 **structure?**

23 **A. Yes.**

EWAZ

EWAZ is a subsidiary of the ultimate parent company EPCOR Utilities Inc.

The City of Edmonton, Canada is EPCOR Utilities Inc.'s sole shareholder.

Since the Company took over operations from Arizona American Water Company in February 2012, the following dividend payments have been made:

December 2012	\$ 10,378,122
March 2014	3,691,533
June 2014	<u>9,892,890</u>
Total	<u>\$ 23,962,545</u>

Further, EWAZ states it targets 75 percent of its net income to dividend to its parent Company in Canada which ultimately benefits the citizens of Edmonton Canada.² EWAZ refused to update its dividend payout information (a copy of all relevant data requests have been included in Attachment B).

Global

Global Water Resources Corp was incorporated in British Columbia to acquire shares of U.S. based Global Water and to actively participate in the management, business and operations of Global Water through its

² See Direct Testimony of RUCO Witness Jeffrey M. Michlik in Docket No. WS-01303A-14-0010, page 7.

1 representation on the board of directors of Global Water and its shared
2 management of Global Water. GWRC owns an approximate 48.1% interest
3 in Global Water.

4
5 Global refused to provide dividend payout information on its other operating
6 systems, but stated Willow Valley has not distributed earnings to its parent
7 company.³ Subsequently, RUCO was able to review the Company's audited
8 financial statement via its website and determined the following liabilities
9 were incurred at the end of December:

10 2014 Dividends Payable approximately \$212,000

11 2013 Dividends Payable approximately \$10,000

12
13
14 **Q. Why is dividend payout information important and relevant to this**
15 **proceeding?**

16 A. Commissioners need to identify financial viability concerns that may arise,
17 as a result of Companies paying excessive dividends to shareholders
18 instead of reinvesting accumulated earnings in deteriorating Arizona water
19 and wastewater plant. Dividends are paid out of retained earnings which
20 is a consideration in assessing the viability of the transaction as well as the
21 merits of a proposed acquisition premium. It is also noteworthy that EWAZ
22 objected to RUCO's review of their board minutes (see RUCO data request

³ See RUCO data request 4.03.

1.04). The board minutes might have contained information that reflected any concerns the board might have had over the acquisition.

IV. EWAZ'S REQUEST FOR AN ACQUISITION PREMIUM

Q. Please provide background details on the Company's proposed sale, transfer of its Certificate of Convenience and Necessity ("CC&N"), and acquisition premium.

A. On April 22, 2015, EWAZ and Global filed a joint application, requesting the Commission approve the sale of Global's Willow Valley Utility System and the transfer of its Certificate of Convenience and Necessity ("CC&N") to EWAZ. The Company also asked for an acquisition premium the details of which would be forthcoming in a supplemental filing. The Company filed a supplement to its application seeking approval and recovery of its price paid in excess of rate base on June 1, 2015. EWAZ is asking for recovery of approximately \$226,803 (i.e. purchase price of \$2,494,834 less \$2,268,031) through a surcharge mechanism as shown below:

Net Utility Plant in Service	\$2,796,377
Less: Advances and Contributions	<u>(\$ 528,346)</u>
	\$2,268,031
 Purchase Price	 \$2,494,834
Less:	<u>(\$2,268,031)</u>
Acquisition Premium	\$ 226,803

1 **Q. Please further explain the Company's proposed acquisition**
2 **adjustment mechanism?**

3 A. The Company has proposed to invest \$1,000,000 in utility plant over a
4 period of five years. Although confusing, the Company would let the
5 Commission decide how much of an incentive the Company should receive
6 - a 10 percent, 15 percent, or 20 percent premium incentive that will
7 eventually be passed on to its ratepayers as an annual surcharge
8 mechanism.

9
10 **Q. Does RUCO have any legal concern with the Company's acquisition**
11 **premium adjustment mechanism?**

12 A. Yes. The Company's proposed acquisition adjustment seems very similar
13 to a System Improvement Benefits ("SIB") Mechanism in which utility plant
14 is built between rate cases. The Arizona Court of Appeals subsequently
15 determined that the SIB was illegal (see Attachment A). This is basically the
16 same situation in this case as the acquisition premium as proposed will
17 create rate increases between rate cases without a fair value
18 determination.⁴

⁴ This is based on RUCO's interpretation of the Company's supplement to application seeking approval of recovery of price paid in excess of rate base, page 6 which states "If approved by the Commission, EWAZ would work with Commission Staff to create standard reporting procedures to monitor annual progress of the additional capital projects, and to phase in the surcharge as projects are completed. In addition, EWAZ would provide a report to Commission Staff annually, summarizing total surcharge revenues collected and provide for early termination of the surcharge should full recovery of the Acquisition Premium occur prior to the authorized term of recovery. EWAZ would not expect the surcharge to continue further than the originally-authorized term, and would accept the risk of non-recovery of the full Acquisition Premium upon expiration of the authorized surcharge period."

1 RUCO also has prudence concerns. The ratemaking principle of prudence,
2 addresses the issue of whether a Company's investment was reasonable,
3 dishonest or wasteful. In this case, EWAZ is asking the Commission to
4 predetermine the prudence of the plant. The determination of prudence is
5 traditionally made when the plant is in the ground and is used and useful.
6 In other words the plant is in service and servicing ratepayers. Here the
7 Company will be asking the Commission to make a determination before
8 the plant is in service and useful to the ratepayers.

9
10 **Q. Did Global Water pay a premium when the Willow Valley Company was**
11 **purchased?**

12 **A. Yes.**

13
14 **Q. Did the Arizona Corporation Commission approve an acquisition**
15 **adjustment when Global purchased Willow Valley?**

16 **A. No.**

17
18 **Q. Can you briefly describe the acquisition of the Willow Valley Company**
19 **when purchased by Global Water Company?**

20 **A. Yes.** The Willow Valley acquisition was part of the West Maricopa Combine
21 that was purchased by Global in 2006. Global paid approximately \$55.4
22 million for the West Maricopa Combine and approximately \$45.8 was
23 recorded as Goodwill. As of December 31, 2011, the Goodwill balance

1 (acquisition premium) on Global's Audited Financial Statements related to
2 the purchase of the West Maricopa Combine was \$13,081,831 of which
3 \$398,499 was attributable to Willow Valley.⁵
4

5 **Q. Has there been an "impairment" adjustment recorded on the books of**
6 **Willow Valley since that time and if there has been why that is**
7 **important?**

8 **A.** Yes. An impairment adjustment of \$175,837⁶ was recorded in June 2015.
9 An impairment adjustment is recorded when the fair value of the assets that
10 were purchased is less than the book value of the assets. In other words
11 Global overpaid for the assets and now the excess purchase price is being
12 written off to expense. Obviously, RUCO is concerned that EPCOR will be
13 following in the same footsteps as Global did when it originally purchased
14 the Willow Valley System. Over-paying for the assets involved in the
15 purchase and at some future date the excess payment could be impaired
16 and ultimately written off to expense. This type of ratemaking incentivizes
17 overpayment by the large utility companies which is bad public policy and
18 perhaps explains the purchase here.
19
20
21

⁵ See Company response to RUCO DR No. 3.04

⁶ See Company response to RUCO DR No. 3.06

V. DUE DILIGENCE

Q. Did RUCO examine EWAZ's due diligence work papers related to the sale price of Willow Valley?

A. Yes. Both myself and Mr. Mease visited EWAZ's corporate headquarters in Arizona on August 28, 2015.

Q. Did the Company do any type of Net Present Value Analysis ("NPV") or revenue/cash stream projection analysis?

A. RUCO is not sure. The Company stated it did in response to RUCO data request number 4.04, however, during our visit on August 28th, we were informed that no such analysis was performed. RUCO asked the Company to explain the discrepancy, but RUCO has not received a response at the time of this filing.

Q. Should acquiring utility companies do a NPV analysis?

A. Yes. Companies will typically perform a NPV analysis of future revenue streams to determine if the acquisition will be profitable and if the investment will provide the expected returns over a defined period of time. Companies can put themselves in a difficult financial situations if such analyses are not performed. When earnings suffer in a regulated environment it's the ratepayers who end up paying for these deficiencies.

1 **Q. How did the Company determine that a ten percent acquisition**
2 **premium was warranted in this case?**

3 A. In response to RUCO 3.02, EWAZ stated "The fair market value was
4 determined through negotiation of an arms-length transaction between
5 unrelated parties. A value based on a multiple applied to the calculation of
6 rate base was the result of protracted negotiations and represented the
7 lowest multiple the seller was willing to accept to sell their assets and forego
8 their reasonable expectation of returns on the capital investments their
9 investors have made in the provision of service to the system's customers."

10
11 RUCO's interpretation is that this is the lowest price that Global was willing
12 to accept. In this case, it does not make sense to invest almost \$2.5 million
13 in a water system that EWAZ may not earn a return on its investment or
14 worse recovery of its investment. Unless of course, the Company can pass
15 the costs on to ratepayers in the form of an acquisition premium.
16

17 **VI. GENERIC DOCKET NO. WS-00000A-14-0198**

18 **Q. Was there a generic Commission docket opened recently to discuss**
19 **Acquisitions and Consolidations in Arizona's Water & Wastewater**
20 **Industry?**

21 A. Yes, generic docket WS-00000A-14-0198, was opened "In the matter of the
22 Commission's inquiry into the possible development of regulatory policies

1 and strategies to evaluate and potentially encourage consolidation
2 concerning Arizona's water and wastewater utilities industry."

3
4 **Q. Did RUCO co-author a white paper on the issue along with Paul Walker**
5 **chairman, Arizonans for Responsible Water a trade group for the water**
6 **industry in Arizona?**

7 A. Yes, this was docketed on June 20, 2014.

8
9 **Q. Did RUCO withdraw its support of the paper?**

10 A. Yes. On June 23, 2014 RUCO withdrew its support. Unfortunately, RUCO
11 could no longer support the White Paper it co-authored in good faith
12 because it was unsure that its underlying principles will be adhered to by
13 the Commission. However, a few of the excerpts from that paper are
14 illustrative.

15
16 The authors' reference : Judge Learned Hand, one of America's greatest
17 jurists, in the 1943 *Niagara Falls Power Co.* decision, and Professor James
18 Bonbright, who wrote "Principles of Public utility Rates". These scholars
19 noted that there are two sources that must be considered when determining
20 the justness of an acquisition adjustment. If the rate base were to be set at
21 the price paid by the new purchaser, then "the [company] who does not sell
22 is confined for [its rate] base to [its] original cost; [the company who sells
23 can assure the buyer that [it] may use as a base whatever [the buyer] pays

1 in good faith. If the [seller] can persuade the buyer to pay more than the
2 original cost the difference becomes a part of the [rate] base and the public
3 must pay rates computed upon the excess. Surely this is a most undesirable
4 conclusion. - *Niagara Falls Power Co. v. Federal Power Commission*, 137
5 F (24 787,793 (1943)

6
7 Judge Hand went on to further note that if the regulator simply allows any
8 cost above original cost to be included in rate base, the seller will "assure
9 the buyer that [it] may use as a base whatever [the buyer] pays in good
10 faith." This will increase sales, but it will do so by changing the economics
11 so that buyers become more indifferent to the purchase price, and sellers
12 realize that the regulatory price constraint no longer exerts a downward
13 force on the price they ask."⁷

14
15 "Therefore the Commission should not do what Judge Hand warned about,
16 it should not simply allow any cost above original cost to be included in rate
17 base."⁸

18
19 Likewise, Professor Bonbright in "Principles of Public Utility Rates," stated
20 that "Investors are not compensated for buying utility enterprises from their

⁷ Please see *The Challenges of Consolidating an Industry* by Pat Quinn, BS, MS, Mathematics and Paul Walker, BS, MBA, Business Administration. Page 17.

⁸ Ibid at 18.

1 previous owners... Instead, they are compensated for devoting capital to the
2 public service."⁹
3

4 **Q. Interestingly enough was EWAZ mentioned in the white paper?**

5 **A.** Yes. "Sometimes, that sunk cost is adequately compensated by the
6 opportunity to grow the acquired entity or simply through the revenue
7 stream from the acquired company. An example of that sort of acquisition
8 is EPCOR's acquisition of Chaparral Water in Fountain Hills. EPCOR paid
9 an acquisition cost approximately 30% higher than Chaparral's book value,
10 but the economics didn't necessitate an acquisition adjustment.
11

12 That example comes with a huge caveat - Chaparral Water was, by all
13 accounts, a successful, capable, well-managed company with more than
14 adequate financial, managerial, and technical ability. ***What Acquisition***
15 ***Adjustments and a Consolidation policy must address are companies***
16 ***that aren't viable, or are in danger of falling into crisis because they***
17 ***lack the financed, managerial, and technical ability to deal with current***
18 ***and looming issues*** (such as, e.g., Arizona's drought.)"¹⁰
19
20
21

⁹ Ibid at 17.

¹⁰ Ibid. at 17

VII. PRIOR STAFF AND COMMISSION POLICY

Q. Has Staff proposed a policy for class D and E water system Acquisitions?

A. Yes (see Attachment C).

Q. Did Staff layout six general conditions that a water company must meet in order to qualify for an acquisition adjustment?

A. Yes. Staff stated that the following six conditions must be proven by a preponderance of the evidence in order to obtain an acquisition adjustment:

1. The acquired Company is a Class D or E.
2. The acquisition will not negatively affect the viability of the acquirer.
3. The acquired system's customers will receive improved service in a reasonable timeframe.
4. The purchase price is fair and reasonable (even though that price may be more than the original cost less depreciation book value) and conducted through an arm's length negotiation.
5. The recovery period for the acquisition adjustment should be for a specific minimum time.
6. The Acquisition is in the public interest.

1 **Q. Did Staff update its acquisition policy?**

2 A. Yes (see Attachment C). On March 19, 2012, Staff filed a memorandum
3 discussing acquisition premiums again.
4

5 **Q. Has the Commission ever granted an acquisition premium?**

6 A. Based on Staff's analysis the answer is no, based on the definition of a true
7 acquisition premium.
8

9 **VIII. RUCO'S ANALYSIS**

10 **Q. What is RUCO's analysis of Staff's acquisition premium conditions as**
11 **they pertain to the present acquisition?**

12 A. Condition number one – Willow Valley is owned by Global a class A utility,
13 and as such does not qualify under Staff's first condition.
14

15 Condition number two – EWAZ claims they are financially viable, however,
16 in their last rate case just recently completed they claim they were not
17 unless they received a higher Return on Equity ("ROE"). Further, RUCO
18 also noted several legal disputes that may or may not have been settled
19 which could affect the Company's financial viability (see Attachment D).
20

21 Condition number three – There is no evidence of improved service in a
22 reasonable timeframe. There are no ADEQ violations or ADWR violations.

1 There is a reliable source of water, capacity, distribution, and customer
2 service.

3
4 Condition number four – One can argue whether the purchase is an arm's
5 length transaction or not, since there may or may not have been an
6 adequate financial analysis conducted. (i.e. NPV analysis)

7
8 Condition number five – The Company has offered various payback
9 periods.

10
11 Condition number six – RUCO does not believe this acquisition is in the
12 public interest. The water company is not insolvent. The company is able to
13 serve water that meets the quality standards as set forth in the Safe Drinking
14 Water Act. Global is a class A utility and has access to financial markets.
15 EWAZ could not provide any efficiencies and/or economies of scale above
16 what Global is providing. There are no clear quantifiable and substantial
17 benefits to ratepayers that will result.

18
19 Simply transferring ownership of a utility from one class A utility to another
20 class A utility does not warrant an acquisition adjustment.

21
22 Likewise, in Staff's updated policy memo, the Company fails to meet any of
23 following conditions:

1. Demonstrating clear, quantifiable and substantial benefits realized by ratepayers that are unlikely to have been realized had the transaction not occurred.
2. Balancing the value of the realized benefits against the rate impact.
3. Granting any recovery of an acquisition premium over an extended time and requiring continued recovery to be re-justified in subsequent rate proceedings to encourage continuous delivery of improved, quality service.

Q. Are there any other resources that RUCO used in its analysis?

A. Yes (see Attachment E and Attachment F). Again, reasons for allowing an acquisition adjustment seem to be similar in nature, as shown in (Attachment E).

1. When acquisitions represent an essential or desirable part of an integration of facilities program devoted to better serving the public,
2. When acquisitions are clearly in the public interest, because operating efficiencies offset the excess price over net original cost; and
3. When acquisitions are determined to involve arm's-length bargaining.

1 Similarly RUCO reviewed other Public Utility Commissioners' policies on
2 Acquisition Adjustments (see Attachment F). Again *the results are the*
3 *same, they are very limited and when an acquisition was granted it*
4 *must benefit the ratepayers.*

5
6 **IX. RUCO'S RECOMMENDATION**

7 **Q. What is RUCO's recommendation?**

8 A. RUCO recommends that no acquisition premium be authorized by the
9 Commission in this case, simply because there are no benefit(s) to
10 ratepayers in this case.

11
12 **X. ACCUMULATED DEFERRED INCOME TAX ("ADIT") ISSUE**

13 **Q. Please explain the term Accumulated Deferred Income Tax.**

14 A. In its simplest form, ADIT is a timing difference between what is recorded
15 on the Company's books and what the Company records for tax purposes.
16 Generally the difference arises based on the use of straight line depreciation
17 for book purposes which the National Association of Regulatory
18 Commissioners ("NARUC") mandates and the use of accelerated
19 depreciation for Federal and State tax reporting purposes. This causes
20 higher depreciation expense for tax purposes than for regulatory book
21 purposes in the earlier years and then this timing difference reverses in later
22 years. The difference is a source of interest-free funds, provided by
23 ratepayers and not investors. This accumulated balance of interest-free

1 funds (ADIT) is available to the utility to further invest until it is then needed
2 to fund the taxes due and payable in the later years.

3
4 **Q. Does the Company intend to carry forward Global's ADIT balance on**
5 **its books?**

6 A. Based on Staff data request 4.6, EWAZ does not give any recognition of
7 Global's ADIT credit of \$293,862 offset by a \$33,638 ADIT debit for a net
8 ADIT credit of \$260,224.

9
10 **Q. Please elaborate?**

11 A. Generally, the ADIT balance serves as a reduction to rate base in rate
12 proceedings, and benefits ratepayers. However, in an asset sale as is the
13 case here, the deferred income tax balances remain with the seller. So as
14 a result of this accounting transaction, ratepayers in Willow Valley will lose
15 the benefit of \$260,224, which would have provided rate relief in future rate
16 case proceedings. This is another reason why EWAZ's acquisition premium
17 should be denied.

18
19 **Q. Can something be done to ameliorate this inequity?**

20 A. Yes. Commissions across the country have approved ratepayer protection
21 mechanisms (hold harmless provisions). ~~In this case the Commission could~~
22 ~~as part of the sale of assets and transfer of the CC&N, order EWAZ to~~

1 ~~transfer the ADIT balance and reclassify it as a regulatory liability for~~
2 ~~regulatory ratemaking purposes.~~

3
4 Q. What is RUCO's recommendation?

5 A. RUCO recommends that ratepayers be held harmless ^{of the effects} and ~~that the~~ ADIT
6 ~~balance of \$260,224 also be transferred to EWAZ, and reclassified as a~~
7 ~~regulatory liability for ratemaking purposes,~~ which is just good public policy.
8 (See Succubutal Testimony of Ralph C. Smith)

9 Q. Does this conclude your direct testimony?

10 A. Yes.
11

ATTACHMENT A

IN THE
ARIZONA COURT OF APPEALS
DIVISION ONE

RESIDENTIAL UTILITY CONSUMER OFFICE, an agency of the State
of Arizona, *Appellant*,

v.

THE ARIZONA CORPORATION COMMISSION, *Appellee*.

ARIZONA WATER COMPANY, *Intervenor*.

No. 1 CA-CC 13-0002
1 CA-CC 14-0001
(Consolidated)
FILED 8-18-2015

Arizona Corporation Commission
No. W-01445A-11-0310
W-01445A-12-0348

AFFIRMED IN PART; VACATED IN PART

COUNSEL

Ridenour Hienton, P.L.L.C., Phoenix
By Scott S. Wakefield
Co-Counsel for Appellant

Residential Utility Consumer Office, Phoenix
By Daniel W. Pozefsky
Co-Counsel for Appellant

Arizona Corporation Commission, Legal Division, Phoenix
By Janice M. Alward, Wesley C. Van Cleve, Charles H. Hains, Bridget A.
Humphrey
Counsel for Appellee Arizona Corporation Commission

Bryan Cave, L.L.P., Phoenix
By Steven A. Hirsch, Rodney W. Ott
Counsel for Intervenor Arizona Water Company

OPINION

Presiding Judge Margaret H. Downie delivered the Opinion of the Court,
in which Judge Kenton D. Jones and Judge Jon W. Thompson joined.

D O W N I E, Judge:

¶1 The Residential Utility Consumer Office ("RUCO") appeals two decisions by the Arizona Corporation Commission ("Commission") that adopted a system improvement benefits ("SIB") mechanism permitting Arizona Water Company ("AWC") to collect surcharges from utility customers in between rate cases for defined capital expenditures. Because we conclude the SIB mechanism does not comply with the Arizona Constitution's mandate that the Commission determine a public service corporation's fair value when setting rates, we vacate the approval of that rate-making device. However, we affirm the Commission's determination of the appropriate return on equity.

FACTS AND PROCEDURAL HISTORY

I. The Parties

¶2 The Commission is a constitutionally created entity that, among other things, regulates the rates charged by public service corporations. *See* Ariz. Const. art. 15, §§ 2-3. AWC — a privately held for-profit corporation — is a monopoly water utility whose rates are set by the Commission; AWC provides water service to nineteen separate systems in Arizona. RUCO is a state agency established to represent the interests of residential utility consumers in Commission proceedings. *See* A.R.S. § 40-462.

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II. Eastern Group Case

¶3 In August 2011, AWC filed an application with the Commission to increase rates for its eastern group water systems ("Eastern Group Case"). As relevant here, AWC requested: (1) a return on equity ("ROE") of 12.5%¹ and (2) a distribution system improvements charge ("DSIC") that would permit AWC to recover, in between rate cases, certain capital costs for improvement projects related to its distribution system and aging infrastructure. RUCO intervened in the Commission proceedings.

¶4 An administrative law judge ("ALJ") held a multi-day hearing on AWC's application. Commission staff ("Staff") and RUCO both opposed the proposed DSIC. Staff expressed concern that it would alter "the balance of ratemaking lag by reducing lag time for recovery of depreciation and return on plant investments, to the benefit of AWC and the detriment of its ratepayers," and Staff also argued "that allowing recovery of capital improvement costs between regular rate cases results in less scrutiny of plant investments both as to prudence and the used and usefulness of the plant." In the alternative, Staff recommended several conditions that should apply to any DSIC-type mechanism the Commission might ultimately approve.

¶5 The ALJ recommended that the Commission set the ROE at 10.55% and that it deny the requested DSIC. After considering the ALJ's written opinion and recommendations, the Commission approved a rate increase for AWC, setting the ROE at 10.55%. The Commission remanded the DSIC issue "to allow the parties the opportunity to enter into discussions regarding AWC's DSIC proposal and other DSIC like proposals."

¶6 All parties except RUCO subsequently entered into a settlement agreement in the Eastern Group Case ("Eastern Group Settlement Agreement"). That agreement included a modified version of the DSIC, now called a SIB.

¶7 An ALJ conducted a hearing regarding the Eastern Group Settlement Agreement, with RUCO opposing its approval. With some

¹ As we discuss *infra*, ¶ 53, the ROE is intended to provide AWC with a fair rate of return on the value of property it employs for public service.

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Opinion of the Court

suggested modifications, the ALJ recommended that the Commission approve the Eastern Group Settlement Agreement, including the SIB mechanism, but also recommended that the ROE be reduced from 10.55% to 10.00%.

¶8 The Commission adopted most of the ALJ's recommendations regarding the Eastern Group Settlement Agreement, but, by majority vote, maintained the ROE at the previously approved level of 10.55%.² The Commission also required AWC to provide more documentation with its surcharge applications than the settlement agreement contemplated. RUCO filed an application for rehearing. After further evidentiary proceedings, the ALJ again concluded the SIB was appropriate and again recommended the Commission reduce the ROE to 10.00%.

¶9 In its final decision, by a 3-2 vote, the Commission approved the SIB mechanism and maintained the ROE at 10.55%. RUCO filed a timely notice of appeal.

III. Northern Group Case

¶10 In August 2012, AWC filed an application with the Commission seeking rate increases for its northern group water systems ("Northern Group Case"). AWC's application included a DSIC proposal similar to that requested in the Eastern Group Case. RUCO intervened in the Northern Group Case as well.

¶11 All parties except RUCO entered into a settlement agreement in April 2013 ("Northern Group Settlement Agreement"). The agreement incorporated the SIB determination from the Eastern Group Case. After an evidentiary hearing, an ALJ recommended that the Commission approve the Northern Group Settlement Agreement.

¶12 The Commission adopted the ALJ's proposed order. However, it made the agreed-upon SIB mechanism "subject to additional modifications that may be made by the Commission" in the Eastern Group Case. RUCO filed an application for rehearing, but its request was denied by operation of law pursuant to A.R.S. § 40-253(A) ("If the

² Commissioner Brenda Burns dissented, stating that "AWC ratepayers should not be asked to pay for an elevated ROE while also being the test case for a newly approved SIB."

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commission does not grant the application [for rehearing] within twenty days, it is deemed denied.”).

¶13 RUCO filed a timely notice of appeal. By stipulation of the parties, we consolidated the Eastern Group and Northern Group cases for purposes of appeal. We also granted AWC’s motion to intervene. This Court has jurisdiction over the consolidated appeals pursuant to A.R.S. § 40-254.01(A).

IV. The SIB Mechanism³

¶14 The SIB at issue in both the Eastern Group and Northern Group cases is a form of tariff that permits AWC, with Commission approval, to add surcharges to customers’ water bills for up to five years to recoup certain capital costs (depreciation expenses and pre-tax return on investment) of defined infrastructure replacement projects that AWC completes prior to its next rate case. Capital expenditures subject to SIB-based surcharges include:

- Transmission and Distribution Mains
- Fire Mains
- Services, including service connections
- Valves and valve structures
- Meters and meter installations
- Hydrants

¶15 AWC may request surcharges only for completed projects that are “actually serving customers.” Before imposing a surcharge, AWC must apply to the Commission and submit specified documentation. The Commission is required to approve or disapprove each surcharge application, and Staff and RUCO have 30 days from each application’s filing to dispute a surcharge request. Each surcharge is “capped annually at five percent of the revenue requirement authorized” in Commission Decision No. 73736. AWC customers receive an “Efficiency Credit” of

³ The SIB mechanism is a type of DSIC. At times, we discuss evidence and testimony regarding a DSIC that also applies to the SIB. However, the SIB mechanism that the Commission ultimately approved differs in some material respects from the DSIC that AWC initially proposed. Our legal analysis is based on the SIB’s terms and methodology.

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“five percent of the SIB revenue requirement.”⁴ The SIB mechanism contemplates an annual “true-up,” or reconciliation, pursuant to which any “under- or over-collected SIB revenues shall be recovered or refunded” to customers “by means of a fixed monthly true-up surcharge or credit.”

DISCUSSION

I. Constitutionality of SIB Mechanism

¶16 RUCO contends the SIB mechanism violates the Arizona Constitution’s mandate that the Commission determine the fair value of a public service corporation’s property when setting rates. According to RUCO, allowing the SIB-based surcharges in between rate cases circumvents this constitutional requirement.

¶17 Whether the SIB mechanism runs afoul of the constitution is a question of law that we review *de novo*. See *Sierra Club – Grand Canyon Chapter v. Ariz. Corp. Comm’n*, ___ Ariz. ___, ¶ 15, ___ P.3d ___ (App. July 23, 2015) (appellate courts are not bound by Commission’s legal conclusions and must “determine independently whether the Commission erred in its interpretation of the law”); *Ariz. Water Co. v. Ariz. Corp. Comm’n*, 217 Ariz. 652, 656, ¶ 10, 177 P.3d 1224, 1228 (App. 2008) (in reviewing Commission decisions, appellate courts review questions of law *de novo*). RUCO bears the burden of persuasion. See A.R.S. § 40-254.01(E) (litigant challenging Commission decision “must make a clear and satisfactory showing that the order is unlawful”).

A. Fair Value Determination Requirement

¶18 “The Arizona Corporation Commission, unlike such bodies in most states, is not a creature of the legislature, but is a constitutional body which owes its existence to provisions in the organic law of this state.” *Ethington v. Wright*, 66 Ariz. 382, 389, 189 P.2d 209 (1948). Under the Arizona Constitution, the Commission has plenary power to set “just and reasonable rates and charges” for public service corporations. Ariz. Const. art. 15, § 3. Article 15, Section 3 provides, in pertinent part:

⁴ The two five-percent figures apply to different amounts. The cap on each surcharge is five percent of the revenue requirement authorized by the Commission in AWC’s most recent rate case, whereas the efficiency credit is five percent of the SIB revenue requirement, as defined in the settlement agreements.

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The corporation commission shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the state for service rendered therein

Id.

¶19 The Commission's plenary power over rate-making, though, is not unfettered. Among other things, our constitution requires the Commission to "ascertain the fair value of property" when it sets rates. Ariz. Const. art. 15, § 14. Section 14's mandate "is an imperative. The commission is charged with an affirmative duty to act." *US West Commc'ns, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 245, ¶ 11, 34 P.3d 351, 354 (2001) ("*US West*"). "[A]scertaining the fair value of property of public service corporations is a necessary step in prescribing just and reasonable classifications, rates, and charges." *Ethington*, 66 Ariz. at 392, 189 P.2d at 216; *see also* *Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328 (1976) ("[T]he Commission is required to find the fair value of the company's property and use such finding as a rate base for the purpose of determining what are just and reasonable rates.").

¶20 Surcharges trigger the constitutional requirement for a fair value determination. *See Residential Util. Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 589, ¶ 1, 20 P.3d 1169, 1170 (App. 2001) ("*RUCO*"). Indeed, the parties here acknowledge that "[t]he SIB mechanism is a ratemaking device."

B. Exceptions to Fair Value Determination Requirement

¶21 Arizona's appellate courts have recognized two relatively narrow exceptions to the constitutional requirement that the Commission determine the fair value of a utility's property when setting rates: automatic adjustor clauses and interim rates. *See id.* at 591, ¶ 11, 20 P.3d at 1172. As we discuss *infra*, the SIB mechanism fits within neither exception.

1. Automatic Adjustor Clauses

¶22 In approving the SIB mechanism, the Commission labeled it an adjustor mechanism. We disagree. *Cf. id.* at 593, ¶ 21, 20 P.3d at 1174 ("If ever there was a situation 'fraught with potential abuse,' it occurs

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when the Commission of its own volition has the ability to declare any rate increase an 'automatic adjustment.'").

¶23 An automatic adjustor mechanism permits "rates to adjust automatically, either up or down, in relation to fluctuations in certain, narrowly defined, operating expenses." *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978). Adjustor mechanisms "usually embody a formula established during a rate hearing to permit adjustment of rates in the future to reflect changes in specific operating costs, such as the wholesale of gas or electricity." *Id.* The purpose of an automatic adjustor mechanism is to pass on to customers certain naturally fluctuating costs so that the utility neither benefits nor suffers a diminished return from those costs. *Id.*

¶24 William Rigsby, Chief of Accounting and Rates for RUCO, described the characteristics of a typical automatic adjustor clause as follows:

When I think of an adjuster mechanism, I think of something along the lines of like a purchased gas adjuster mechanism, where the company has to . . . buy natural gas on the open market, or an electric company . . . has to buy power . . . on the grid in the wholesale market and so forth. And so the cost of that either natural gas or electricity is passed on to the ratepayer at no profit to the company, and that's the reason that it's implemented, is because of the price fluctuations of the commodity in the marketplace. It's a two-way street. If the prices go down, then consumers see a credit on the bill. If prices go up, then, of course, they go ahead and they pay that. Whereas in the case of . . . a DSIC, it's not a two-way street.

¶25 Rigsby's testimony is consistent with our own jurisprudence regarding automatic adjustor clauses. See, e.g., *Mountain States Tel. & Tel. Co. v. Ariz. Corp. Comm'n*, 137 Ariz. 566, 569, 672 P.2d 495, 498 (App. 1983) (An automatic adjustment clause is "a device that allows a rate to adjust automatically, either up or down in relation to fluctuations in certain, narrowly defined, operating expenses."). RUCO's view is also aligned with the position Staff took at the outset of the Eastern Group Case. In Phase I of that proceeding, Staff stated that adjustor mechanisms are used to "allow utilities to pass on to customers changes in certain specific volatile costs outside of the utility's control, such as purchased power costs." Staff also correctly noted that "rate adjustors outside of a rate case

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are the exception rather than the rule and [are] very limited in what they can do."

¶26 Under the SIB mechanism, surcharges will not fluctuate in amount within an annual cycle, and they will never decrease. Moreover, AWC is being allowed to recoup *capital expenditures*, rather than "narrowly defined operating expenses" that naturally fluctuate. As such, the SIB mechanism lacks essential attributes of an automatic adjustor clause and does not fall within that exception to the constitutional fair value determination requirement.

2. Interim Rate

¶27 Interim rates assessed on a temporary basis in between rate cases may also be exempt from the constitutional fair value determination requirement. The interim rate exception, though, "is limited to circumstances in which: (1) an emergency exists; (2) a bond is posted by the utility guaranteeing a refund to customers if interim rates paid are higher than the final rates determined by the Commission; and (3) the Commission undertakes to determine final rates after a valuation of the utility's property." *RUCO*, 199 Ariz. at 591, ¶ 12, 20 P.3d at 1172.

¶28 During the Commission proceedings, AWC did not assert that emergency circumstances exist. It instead described its infrastructure replacement needs as "extraordinary," and on appeal, it characterizes them as "exceptional." AWC estimates the cost of needed improvements in the Eastern Group systems alone at \$67 million over a ten-year period.

¶29 In the first phase of the Eastern Group Case, Staff did not quarrel with AWC's cost estimates or dispute the notion that infrastructure at the end of its useful life must be replaced. Staff, however, did not consider AWC's situation an emergency or even an "extraordinary circumstance." Jeffrey Michlik, Public Utilities Analyst for the Commission, testified:

Q. Do you consider infrastructure replacement to be an extraordinary circumstance?

A. No. . . . That's something we expect of all the water companies that are public service companies here. They should . . . supply customers with safe and reliable drinking water, with or without a DSIC.

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Q. Does the dollar amount of [the repairs] et cetera, drive the determination of whether something is extraordinary or not?

A. It could, I mean if it's a huge amount.

Q. . . . In this case [AWC] has talked about a \$67 million expense that they anticipate in infrastructure replacement. . . . Does Staff consider that . . . significantly high to . . . deem that circumstance extraordinary?

A. No.

Staff contended AWC was proposing a DSIC-type mechanism "for routine expenditures" that was "unjustified." In a brief filed during Phase I of the Eastern Group Case, Staff wrote:

[O]ther cost recovery mechanisms in use in Arizona all address extraordinary circumstances outside the utility's control, such as the fluctuating cost of natural gas or a federal mandate requiring the addition of massive amounts of plant. This case seeks to recover the cost of replacing aging infrastructure. The most basic laws of science and nature are that materials have a limited life-span. They deteriorate and must be replaced. [AWC] knew from the time it entered the market that someday the infrastructure would require replacement. [AWC] could and should have anticipated this event and prepared for the same, but failed to do so. [AWC] has some control over the rate of deterioration, by performing routine repairs and maintenance. By their own admission, they cut maintenance expenses "to the bone" in 2008. Staff has expressed concern that this has caused a more rapid deterioration of plant. To a significant extent, the circumstances in which AWC now finds itself are of its own making. The customer should not be required to bear the burden of the Company's decisions.

¶30 The ALJ's Opinion and Order noted "plentiful evidence" that certain AWC systems have degraded and that leaks and breaks are "occurring at excessive rates," requiring replacement of infrastructure "at a much faster rate than [AWC] has historically done." But the ALJ concluded the situation was not "exceptional," so as to warrant "the creation of and authorization to use a nontraditional ratemaking device such as the DSIC." See *RUCO*, 199 Ariz. at 592, ¶ 18, 20 P.3d at 1173

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("Nothing in the record indicates that the increase in CAP water expense rose to the level of an emergency situation, thereby making [the utility] eligible for an interim rate.").

¶31 In considering the ALJ's findings and recommendations, the Commission similarly found no emergency and cited AWC's acknowledgement it had not been "'ambushed' by the need to replace its aging infrastructure." The Commission further noted that, "[i]n spite of AWC's decision to cut operating costs, AWC has consistently continued to pay its shareholders dividends, paying \$4,287,600 in 2008, 2009, and 2010. . . . AWC increased the amount of dividends in 2011, after having held dividends steady for three years."

¶32 The settlement agreements that were later negotiated also do not state that an emergency exists or describe circumstances that would ordinarily be considered an emergency. *See, e.g., Garvey v. Trew*, 64 Ariz. 342, 354, 170 P.2d 845, 853 (1946) ("The word 'emergency' has a well understood meaning. It is defined and understood as: 'An unforeseen combination of circumstances which calls for immediate action.'"); *see also Hunt v. Norton*, 68 Ariz. 1, 11, 198 P.2d 124, 130 (1948) ("'Emergency' does not mean expediency, convenience, or best interests."). Instead, the Eastern Group Settlement Agreement provides, in pertinent part:

It is necessary for AWC to undertake a variety of system improvements in order to maintain adequate and reliable service to existing customers. AWC is also required to complete certain system improvements in order to comply with requirements imposed by law. The Signatory Parties acknowledge that these projects are necessary to provide proper, adequate and reliable service to existing customers

In its final approval of the settlement agreements, the Commission again made no finding of emergency circumstances and noted AWC's concession "that its infrastructure replacement needs have been developing for a long time."

¶33 Because AWC neither claimed nor established the requisite emergency circumstances, the interim rate exception to the constitutional fair value determination requirement does not apply.

C. Compliance with Fair Value Determination Requirement

¶34 Absent a valid automatic adjustor mechanism or interim rate, the Commission "cannot impose a rate surcharge based on a specific cost increase without first determining a utility's fair value rate base." *RUCO*, 199 Ariz. at 589, ¶ 1, 20 P.3d at 1170. The question thus becomes whether the SIB mechanism satisfies this constitutional mandate.

¶35 Arizona is a regulated monopoly state. *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 111 Ariz. 74, 76, 523 P.2d 505, 507 (1974). "The monopoly is tolerated only because it is to be subject to vigilant and continuous regulation by the Corporation Commission." *Davis v. Corp. Comm'n*, 96 Ariz. 215, 218, 393 P.2d 909, 911 (1964). One important component of the Commission's "vigilant and continuous" regulatory role is determining and using fair value when setting a monopolistic utility's rates. In discussing the fair value determination requirement more than a century ago, our supreme court stated:

In order that the Corporation Commission might act intelligently, justly, and fairly between the public service corporations doing business in the state and the general public, section 14 was written into the Constitution The "fair value of the property" of public service corporations is the recognized basis upon which rates and charges for services rendered should be made, and it is made the duty of the Commission to ascertain such value, not for legislative use, but for its own use, in arriving at just and reasonable rates and charges

State v. Tucson Gas, Elec., Light & Power Co., 15 Ariz. 294, 303, 138 P. 781, 784-85 (1914); see also *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956) ("It is clear . . . that under our constitution as interpreted by this court, the commission is required to find the fair value of the company's property and use such finding as a rate base for the purpose of calculating what are just and reasonable rates.").

¶36 A fundamental underpinning of the fair value determination requirement is the principle that the public has "the right to demand" that a public utility operate "with reasonable efficiency and under proper charges." *City of Phx. v. Kasun*, 54 Ariz. 470, 475, 97 P.2d 210, 212 (1939); see also *Ariz. Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 292, 830 P.2d 807, 813 (1992) (The Commission must use its "powers to regulate public service corporations in the public interest."). Although our constitution

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"does not establish a formula for arriving at fair value, it does require such value to be found and used as the base in fixing rates." *Simms*, 80 Ariz. at 151, 294 P.2d at 382; *see also* *Ariz. Corp. Comm'n v. Ariz. Water Co.*, 85 Ariz. 198, 202, 335 P.2d 412, 414 (1959) ("No formula is given for determining fair value . . . but the Commission must establish the rate base on the basis of fair value and that alone."). The fair value determination is intended to avoid "the harsh extremes of the rate spectrum" and to ensure that both consumers and public service corporations are treated fairly. *US West*, 201 Ariz. at 246, ¶ 21, 34 P.3d at 355.

¶37 The Commission suggests the SIB mechanism is constitutionally permissible because it is akin to step rate increases the Arizona Supreme Court discussed in *Arizona Community Action Ass'n v. Arizona Corp. Commission*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979) ("ACAA"). We conclude otherwise.

¶38 ACAA includes *dicta* stating that, in the context of a rate case, the Commission may consider construction work in progress ("CWIP") in calculating a utility's fair value and may approve prospective percentage rate increases based on that fair value for a "limited period of time." *Id.* at 230-31, 599 P.2d at 186-87. The court observed that "[t]he adjustments ordered by the Commission in adding the CWIP to [the] determination of fair value were adequate to maintain a reasonable compliance with the constitutional requirements *if used only for a limited period of time.*" *Id.* at 231, 599 P.2d at 187 (emphasis added). But even accepting this language as persuasive authority, as the Commission urges, the SIB mechanism at issue here differs materially from the step rate increases discussed in ACAA.

¶39 ACAA suggests that, with Commission authorization, a utility may charge stepped-up rates for a limited period of time to account for CWIP that was reviewed and approved by the Commission during a rate case. Here, however, much of the work that will be subject to SIB-based surcharges was not in progress when AWC's rate case was adjudicated. Under the settlement agreements, AWC may add improvement projects that will be subject to the SIB mechanism. *Cf. Consol. Water Utils., Ltd. v. Ariz. Corp. Comm'n*, 178 Ariz. 478, 482-83, 875 P.2d 137, 141-42 (App. 1993) (affirming non-inclusion of anticipated CWIP in establishing fair value rate base because, among other things, "[t]he amount of actual construction to be undertaken is not known and measureable"). And even if the Commission's review of new projects were to approximate the evaluation occurring during a rate case, unlike the two-year step increases in ACAA, the Commission here has authorized

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AWC to seek surcharges for five years – the entire time span between rate cases.

¶40 Turning next to the question of whether the SIB mechanism's methodology satisfies the constitutional fair value determination requirement, we note that the documentation AWC must submit to obtain approval of surcharges is substantially less than what is required in a rate case. See A.A.C. R14-2-103(A)(1) (delineating financial and statistical information "required to be filed with a request by a public service corporation doing business in Arizona for a determination of the value of the property of the corporation and of the rate of return to be earned thereon, with regard to proposed increased rates or charges"). Moreover, it is undisputed that the Commission will not conduct a full fair value determination when it evaluates AWC's surcharge requests.

¶41 Rigsby testified that RUCO's primary concern with a DSIC-type mechanism is that the Commission will not "take into consideration all of the various ratemaking elements that would be looked at and scrutinized in a general rate case proceeding. That would include such things as revenues, expenses, and, of course, capital expenditures and the prudence considerations for each one of those ratemaking elements." The record supports this concern. As Rigsby observed, the Commission will only be "looking at the capital costs and depreciation expense associated with the plant additions under the SIB, as opposed to an actual test year, where we're looking at all of the ratemaking elements that would . . . include not only plant and accumulated depreciation and such, but other rate base items like accumulated deferred income taxes, customer deposits, working capital." In other words, the SIB mechanism focuses on the marginal effect of the SIB on fair value – an important, but quite limited assessment of fair value. Steve Olea, former Director of the Utilities Division for the Commission, confirmed that "[t]he only thing being considered in the SIB is the plant," not current operating and maintenance expenses, and he acknowledged that "the SIB application doesn't look at all the rate case elements that you would normally look at in a rate case proceeding."

¶42 To be sure, AWC must submit substantial information to the Commission when it requests a surcharge, including project details, "a calculation of the SIB revenue requirement and SIB efficiency credit," a true-up calculation for the prior surcharge period, an analysis of the impact of the SIB Plant on the fair value rate base, revenue, and the fair value rate of return, current balance sheets and income statements, and an earnings test schedule. But although infrastructure costs will be current

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when the Commission considers surcharge requests, other critical valuation factors will be premised on a past rate case that, at the outer reaches of the SIB cycle, will be five years old. Such a process is inconsistent with the mandate that the Commission perform a fair value determination "at the time of inquiry." See *Ariz. Corp. Comm'n*, 85 Ariz. at 201-02, 335 P.2d at 414-15 ("A reasonable judgment concerning all relevant factors is required in determining the fair value of the properties at the time of inquiry. If the Commission abuses its discretion in considering these factors or if it refuses to consider all the relevant factors, the fair value of the properties cannot have been determined under our Constitution."); *Simms*, 80 Ariz. at 151, 294 P.2d at 382 ("Fair value means the value of properties at the time of inquiry.").

¶43 The abbreviated review under the SIB mechanism is particularly problematic given the five-year duration of the surcharges and the compounding effect those surcharges will have on ratepayers over that relatively lengthy period of time. Additionally, the Commission will not be assessing savings or other efficiencies attributable to capital improvements when it approves surcharges. See *Kasun*, 54 Ariz. at 475, 97 P.2d at 212 (public has right to demand that utilities operate with reasonable efficiency); *Scates*, 118 Ariz. at 534, 578 P.2d at 615 (A noted peril of a "piecemeal approach" to rate-making via tariff is that it serves "both as an incentive for utilities to seek rate increases each time costs in a particular area rise, and as a disincentive for achieving countervailing economies in the same or other areas of their operations.").

¶44 In defending its decisions, the Commission cites cases that confirm its broad discretion in setting rates. See, e.g., *Ariz. Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. at 371, 555 P.2d at 329. The Commission, however, lacks discretion to disregard or dilute state constitutional requirements, including the mandate that it determine fair value in setting rates.

¶45 Nor do we agree that *Scates* authorizes a rate increase without a fair value determination based on "exceptional circumstances," as the Commission and AWC suggest. *Scates* reversed an order approving increased telephone rates because the Commission "failed to make any examination whatsoever of the company's financial condition, and to make any determination of whether the increase would affect the utility's rate of return." 118 Ariz. at 537, 578 P.2d at 618. In language unnecessary to its holding, *Scates* continued:

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There may well be exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. We do not decide in this case, for example, whether the Commission could have referred to previous submissions without some updating or whether it could have accepted summary financial information. We do hold that the Commission was without authority to increase the rate without any consideration of the overall impact of that rate increase upon the return [of the company], and without, as specifically required by our law, a determination of [the company's] rate base.

Id.

¶46 To the extent this *dicta* in *Scates* can be read as suggesting that an "exceptional situation" may excuse the constitutional requirement for a fair value determination, we disagree. No Arizona court has so held, and since *Scates*, we have reaffirmed that, absent a valid interim rate or automatic adjustor mechanism, the Commission may not impose rate surcharges without first determining fair value. See *RUCO*, 199 Ariz. at 589, ¶ 1, 20 P.3d at 1171.

¶47 AWC's reliance on *US West* is similarly unavailing. In a fundamentally different context, our supreme court held in *US West* that although a fair value determination is constitutionally mandated when rates are set, in a *competitive* market, the Commission has "broad discretion" to determine what weight to give that determination. *US West*, 201 Ariz. at 246, ¶¶ 19-21, 34 P.3d at 355. We are not dealing here with a competitive market. Nor is our focus on how the Commission may weigh and apply fair value in approving surcharges. At issue is whether the SIB mechanism provides the functional equivalent of a fair value determination. See *Ariz. Corp. Comm'n*, 85 Ariz. at 202, 335 P.2d at 414 (The Commission abuses its discretion if "it refuses to consider all the relevant factors" in determining fair value.). Moreover, *US West* confirms that in the context of a regulated monopoly, the Commission must both determine and use fair value:

[W]hile the constitution clearly requires the Arizona Corporation Commission to perform a fair value determination, only our jurisprudence dictates that this finding be plugged into a rigid formula as part of the rate-setting process. . . . As we have seen, a line of cases nearly as old as the state itself has sustained the traditional formulaic

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approach. The commission . . . correctly points out, however, that those decisions were rendered during a time of monopolistic utility markets. In such a setting, where rates were determined by giving the utility a reasonable return on its Arizona property, the fair value requirement was essential. *We still believe that when a monopoly exists, the rate-of-return method is proper.*

201 Ariz. at 245-46, ¶¶ 17-19, 34 P.3d at 354-55 (emphasis added); *see also Phelps Dodge Corp. v. Ariz. Elec. Power Coop., Inc.*, 207 Ariz. 95, 105 n.8, ¶ 21, 83 P.3d 573, 583 n.8 (App. 2004) ("Although [*US West*] held that this rate-of-return method for rate setting may be inappropriate in a competitive environment, it affirmed the supreme court's long-standing view that this method is properly employed in traditional, non-competitive markets.").

¶48 The Commission and AWC raise colorable policy arguments in support of flexible rate-making tools like the SIB and stress that other jurisdictions have approved similar devices.⁵ We recognize the Commission's legitimate desire to "initiate innovative procedures in an attempt to deal promptly and equitably with increasingly complex regulatory matters," and its corresponding goal of avoiding "a constant series of extended rate hearings [that] are not necessary to protect the public interest." ACAA, 123 Ariz. at 230-31, 599 P.2d at 186-87. But the question before us is not whether the SIB mechanism represents prudent public policy. Our focus is on the propriety of that mechanism given the unique and express provisions of our state constitution.

¶49 The fair value determination requirement imposed by the Arizona Constitution may be cumbersome, time-consuming, and expensive, as the Commission asserts. The answer, though, is not to

⁵ Also in the record are materials describing potentially negative policy implications of DSIC-type mechanisms, including circumvention of regulatory review of rate base items for prudence and reasonableness, elimination of incentive to control costs between rate cases, and rewarding water companies that "imprudently fall behind in infrastructure improvements." Additionally, AWC's reliance on "regulatory lag" as a basis for implementing a DSIC-type mechanism caused Staff to note during Phase I of the Eastern Group Case that "[w]hile utilities tend to decry regulatory lag as causing them to have to wait too long to recover costs, regulatory lag serves a useful purpose in incentivizing a utility to operate efficiently and minimize costs."

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ignore it or to circumvent the constitutional mandate by judicial fiat. See Ariz. Const. art. 2, § 32 ("The provisions of this Constitution are mandatory, unless by express words they are declared to be otherwise."). Although the Arizona electorate has refused to amend the constitutional fair value requirement in recent years,⁶ "[s]hould they think it wise, our citizens are free to amend the Arizona Constitution to reflect changed circumstances." *US West*, 201 Ariz. at 245, ¶ 12, 34 P.3d at 354. Meanwhile, under appropriate circumstances, the Commission may employ alternative rate-making devices approved by our appellate courts if it complies with the well-established requirements for those mechanisms.

¶50 Because the SIB mechanism does not comply with the Arizona Constitution's mandate that the Commission determine and use fair value when setting a monopolistic utility's rates, we vacate the Commission's approval of that rate-making device.

II. Return on Equity

¶51 RUCO also contends the adoption of a 10.55% ROE was arbitrary given the Commission's corresponding approval of the SIB mechanism. To the extent this argument is not moot by virtue of our disapproval of the SIB mechanism, we disagree.

¶52 "[T]he Commission is constitutionally mandated to set fair rates of return on fair value base of public service utilities." *Ariz. Corp. Comm'n v. Citizens Utils. Co.*, 120 Ariz. 184, 188, 584 P.2d 1175, 1179 (App. 1978). "This function cannot be performed by the judiciary and the judicial role is limited . . . to determining whether the Commission's decision was supported by substantial evidence, was not arbitrary and was not otherwise unlawful." *Id.* The Commission exercises discretion in setting an appropriate rate of return. *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

¶53 The Commission considered substantial evidence relevant to the ROE determination. Some of that evidence, including expert opinions, suggested that AWC required both a SIB-type mechanism and a higher

⁶ Arizona voters defeated proposed constitutional amendments to the fair value determination requirement in 1984, 1988, and 2000. *US West*, 201 Ariz. at 245 n.2, ¶ 12, 34 P.3d at 354.

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ROE to complete necessary projects and obtain financing. *See Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 693 (1923) ("The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."). Other testimony posited that the efficiency credit included in the settlement agreements effectively reduces the ROE. Opinions about the appropriate ROE ranged from 8.5% to 12.5%. RUCO took the position that the ROE and SIB mechanism are, to some degree, duplicative, and that the SIB reduces AWC's risk "because it improves cash flow and reduces regulatory lag related to cost recovery of qualifying infrastructure investment."

¶54 Faced with a conflict in the evidence, a majority of the Commission opted to authorize the 10.55% ROE, even while approving the SIB mechanism.⁷ There is support for that decision in the record, and our role is not to reweigh the evidence to determine whether we would reach the same conclusion. *See DeGroot v. Ariz. Racing Comm'n*, 141 Ariz. 331, 335-36, 686 P.2d 1301, 1305-06 (App. 1984) (appellate court does not reweigh evidence to resolve perceived conflicts). We find no abuse of discretion in setting the ROE at 10.55%.

⁷ Commissioners Brenda Burns and Robert Burns dissented. In his written dissent, Commissioner R. Burns stated that the final decision "allows for both a SIB mechanism and a higher return on equity . . . which leads to duplicative recovery." He concluded that permitting "both a SIB and an elevated ROE is not in the best interest of the ratepayers."

RUCO v. ACC
Opinion of the Court

CONCLUSION

¶55 For the reasons stated, we vacate the Commission's approval and adoption of the SIB mechanism but affirm its determination of the appropriate ROE.



Ruth A. Willingham • Clerk of the Court
FILED: ama

ATTACHMENT B

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131

Response provided by: Tom Campbell
Title: EWAZ Legal Counsel

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 1.03

- Q: Work Papers - Please provide a copy of all due diligence work papers created and/or utilized by EPCOR during their analytical review of the Willow Valley Water, Co.
- A: EWAZ objects to RUCO 1.03 to the extent that it seeks information that is not reasonably calculated to lead to the discovery of admissible evidence. EWAZ further objects to RUCO 1.03 to the extent that it seeks information protected by the attorney-client privilege, the work-product doctrine or any other privilege recognized under the law. EWAZ also objects to RUCO 1.03 to the extent that it seeks highly confidential business information or trade secrets.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131

Response provided by: Tom Campbell
Title: EWAZ Legal Counsel

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 1.04

- Q: Minutes of the Board of the Directors – Please provide copies of the minutes of all meetings of the Board of Directors of EPCOR Water Arizona Inc., approving the purchase of Willow Valley Water Co. Inc.
- A: EWAZ objects to RUCO 1.04 to the extent that it seeks information that is not reasonably calculated to lead to the discovery of admissible evidence. EWAZ further objects to RUCO 1.04 to the extent that it seeks information protected by the attorney-client privilege, the work-product doctrine or any other privilege recognized under the law.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming (Part a.)
Title: CEO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Response provided by: Sarah Mahler (Part b.)
Title: Manager, Rates

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.02

Page 1 of 2

Q: Customer Benefits – The Company states the following on page 5, line 1. *“Willow Valley’s customers will benefit from the in-house water utility expertise and resources afforded by EWAZ ownership. EWAZ’s size naturally affords it access to broad in-house utility expertise and resources. The proximity of EWAZ’s other systems will provide additional operational resources and personnel. In addition, EWAZ intends to implement or continue various industry best operating practices in the Willow Valley systems. EWAZ uses various sophisticated maintenance and management systems such as maintenance management, environmental and water quality compliance management, hydraulic modeling, and GIS systems. All these support resources will be deployed in support of the Willow Valley systems to provide reliable and high quality service to customers.”*

Please answer the following questions:

- a. Were these customer benefits not provided by Global Water Resources, Inc. (“Global”)?
 - b. What services or customer benefits will EPCOR Water Arizona, Inc. (“EPCOR”) provide over those offered by Global (e.g. hydraulic modeling, and GIS systems)?
- A:** a. Global Water provided many of the customer benefits identified, including in-house water utility expertise and resources. Also, Global Water implemented best practices for the Willow Valley utility, including a computerized maintenance management system, hydraulic modeling, and GIS. Further, Global Water provided management and additional support resources from its Phoenix-metro area utility operations. However, because EWAZ is larger and has systems in the same region as Willow Valley, this allows access to greater resources in closer proximity.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming (Part a.)
Title: CEO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Response provided by: Sarah Mahler (Part b.)
Title: Manager, Rates

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.02

Page 2 of 2

- b. EWAZ will bring the Willow Valley service area into its operational management systems, which, in addition to the systems already employed by Global, also includes an environmental and water quality compliance management system.

Also, while EWAZ does not waive its right to start collecting customer security deposits in the future, EWAZ does not currently collect security deposits from its customers. We note that Global does hold security deposits, and will be returning any outstanding security deposit balances to the respective customers after the close of this transaction.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming
Title: CEO, Global Water Resources, Inc.

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.05

Q: Water Quality – Is the Willow Valley Water System currently providing safe and reliable drinking water?

A: Yes.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming
Title: CEO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Company Response Number: RUCO 2.06

Q: Water Quality – Does the Willow Valley Water System currently have any Notice of Violations outstanding with the Arizona Department of Environmental Quality? If so please explain.

A: No.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Sarah Mahler
Title: Manager, Rates and Regulatory

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 2.07

Q: Acquisition Premium – Please describe how the Company's acquisition premium was derived?

A: Please see the Company's Response to STF GWB 1.1 and the table below (from STF GWB 1.1)

<u>Descriptions</u>	<u>EPCOR Purchase Price Calculation as of 12/31/2014</u>
Utility Plant in Service	\$5,146,109
CWIP	\$19,767
Total PP&E	\$5,165,876
Accum Depreciation	(\$2,369,499)
Gross Plant	\$2,796,377
AIAC	(\$69,347)
CIAC	(\$458,999)
Net Rate Base	\$2,268,031
 With 10% Acquisition Premium	 1.10
 Purchase Price	 \$2,494,834

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Greg Barber
Title: EPCOR Controller

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 3.01

Q: Please see RUCO DR. No. 2.07 requesting "how the Company's acquisition premium was derived?" The Company's response was as follows:

A: Please see the Company's Response to STF GWB 1.1 and the table below (from STF GWB 1.1)

<u>Descriptions</u>	EPCOR
	Purchase Price Calculation as of 12/31/2014
Utility Plant in Service	\$5,146,109
CWIP	\$19,767
Total PP&E	\$5,165,876
Accum Depreciation	(\$2,369,499)
Gross Plant	\$2,796,377
AIAC	(\$69,347)
CIAC	(\$458,999)
Net Rate Base	\$2,268,031
With 10% Acquisition Premium	1.10%
Purchase Price	\$2,494,834

RUCO can see how the calculation of the purchase price was calculated, however, **please explain how the 10% Acquisition Premium was derived?**

A. The 10% acquisition premium was derived through negotiation, and represented the lowest price premium that would have motivated a sale from the current owner. This negotiated premium was the result of protracted negotiations with the seller who initially indicated an expectation of a higher premium. The formulaic method which defined the acquisition price in this instance as a percentage applied to rate base was agreed to by the parties as a means of defining the final purchase price in recognition of the changes to plant and advances/contributions that can occur during the period between signing a purchase agreement and completion of the regulatory approval process.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Shawn Bradford
Title: EPCOR—VP Corporate Services

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 3.02

Q: On page 2, line 5 of "Supplement to Application" filed on June 1, 2015, it states that the purchase price for the Willow Valley system reflects the fair market value of the assets and operations being purchase." **Can you please explain in detail how the fair market value was determined?**

A: The fair market value was determined through negotiation of an arms-length transaction between unrelated parties. A value based on a multiple applied to the calculation of rate base was the result of protracted negotiations and represented the lowest multiple the seller was willing to accept to sell their assets and forego their reasonable expectation of returns on the capital investments their investors have made in the provision of service to the system's customers.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Shawn Bradford
Title: EPCOR—VP Corporate Services

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 3.03

Q: Also on page 2 on the "Supplement to Application" beginning on line 14 it states, "EWAZ will need to make significant capital investments to increase the reliability and quality of the Willow Valley system, such as replacement of non-operational system valves, installation of a more robust backwash effluent discharge retention system, and necessary maintenance of storage tanks." **If such significant new investments are required to be made by EPCOR, why would a prudent investor pay a ten percent premium?**

A: Willow Valley has made investments and improvements to its systems over the years to address numerous areas of concern. While EPCOR recognizes the need for additional investment to improve system reliability and lower water loss, the negotiated sale price was based on the approved rate base plus a 10 percent premium, which is fair market value for the types of assets being acquired. This acquisition also meets the Commission's objective of industry consolidation for the benefit of customers.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 3.04

Q: Global Water, Inc., paid a negotiated purchase price of \$54,369,889 for the West Maricopa Combine in 2006, of which \$45,809,111 was identified as Goodwill in the Company's audited financial statements for the year ending December 31, 2011. Of the total amount of Goodwill how much was recorded on the books of Willow Valley Water Co., Inc.? Please show the calculations for the amount recorded as Goodwill.

A: Please see the attached Exhibit 3.04 Goodwill Calculation. For clarification, see page 55 of the Audited Financial Statement for the year ended December 31, 2011 for the Company's Goodwill balance, which was approximately \$13,081,831. The Goodwill recorded at Willow Valley for the year ended December 31, 2011 was \$398,499.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 3.05

Q: If there was no Goodwill recorded on the books of Willow Valley, please explain why not?

A: See above response to RUCO 3.04 for the Goodwill calculation.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220
Phoenix, Arizona 85027

Company Response Number: RUCO 3.06

Q: Of the amount recorded as Goodwill on the books of Willow Valley, has there been an impairment adjustment recorded and if so how much was the impairment adjustment?

A: An impairment adjustment of \$175,837 was recorded in June 2015.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01303A-15-0131 and W-01732A-15-0131

Response A1 provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220, Phoenix, AZ 85027

Response A2 provided by: Timothy J. Sabo
Attorney for Willow Valley and Global Water Resources, Inc.

Response to A3 provided by: Sarah Mahler
Manager, Rates

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 4.03

- Q:** Dividend Payouts to both EPCOR and Global's Parent Companies – Please include the dividend payouts to the ultimate parent Company for both EPCOR and Global (from all systems or districts) on a calendar year basis since 2010
- A1:** Willow Valley has not paid dividends to Global Water since the stock acquisition in 2006 as Willow Valley has operated in a loss position for each of the years in question, and has not had earnings available to distribute to the parent company.
- A2:** Dividends or other distributions by other Global Water utilities are not relevant to this docket, which is limited to the approval of the sale of Willow Valley's assets to EPCOR Water Arizona Inc.
- A3:** EWAZ objects to DR RUCO 4.03 to the extent that it is not relevant to the Commission's determination of the present action and is not reasonably calculated to lead to the discovery of admissible evidence. Without waiver of the foregoing objection, the dividends paid to EWAZ's corporate parent for June 2010 to June 2013 are available in the Company's most recently filed rate case, Docket No. WS-01303A-14-0010, at schedule E4 in any of the A-F schedules for that case.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01303A-15-0131 and W-01732A-15-0131

Response provided by: Joanne Ellsworth
Title: Director, Corporate and Regulatory Affairs
Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220, Phoenix AZ 85027

Company Response Number: RUCO 4.02

Q: Acquisition Adjustments – Based on the Answers to data request 4.01, did the Company or predecessor Companies ask for an acquisition adjustment in any prior CC&N case? If so, please identify the Commission Decision and docket number that discusses an acquisition adjustment.

A: This question is not applicable. See the response to RUCO Data Request 4.01.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Greg Barber
Title: Controller

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 4.04

Q: Net Present Value ("NPV") Analysis – Did EPCOR do any type of NPV Analysis or revenue/cash stream projections to support its proposed acquisition of Willow Valley? If no analysis was prepared please explain why not?

A: Yes, we did a NPV Analysis for the Willow Valley acquisition. However, the purchase price was the result of arms-length negotiation between the buyer and seller and represents the lowest acquisition price that the current owner would accept to sell the Willow Valley systems. This negotiated acquisition price was the result of protracted negotiations with the seller who initially indicated an expectation of a higher acquisition price. The NPV analysis performed by EPCOR simply supported that negotiated price.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Greg Barber
Title: Controller

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 4.06

Q: System Improvement Benefits ("SIB") Mechanism – What extent did the SIB have on the negotiated sales price?

A: The SIB did not have any impact on the negotiated sales price. The acquisition price was derived through negotiation, and represented the lowest acquisition price that would have motivated a sale from the current owner. This negotiated acquisition price was the result of protracted, arms-length negotiation between the buyer and seller, who initially indicated an expectation of a higher acquisition price.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220, Phoenix, AZ 85027

Company Response Number: RUCO 4.11

Q. Unexpended CIAC – Does Willow Valley have any unexpended CIAC? If so how much.

A. Willow Valley does not have any unexpended CIAC recorded.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220, Phoenix, AZ 85027

Company Response Number: RUCO 4.18

- Q. Excessive Accumulated Depreciation Balances – Please list the plant accounts that have accumulated depreciation balances that are larger than the plant asset.
- A. Willow Valley does not have any accumulated depreciation balances larger than the related plant asset.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01303A-15-0131 and W-01732A-15-0131

Response provided by: Mike Liebman
Title: CFO, Global Water Resources, Inc.

Address: 21410 N. 19th Ave., Suite 220, Phoenix, AZ 85027

Company Response Number: RUCO 4.19

Q. Debit Accumulated Depreciation Balances – Does Willow Valley have any debit accumulated depreciation balances?

A. Willow Valley does not have any debit accumulated depreciation balances.

COMPANY:
DOCKET NO:

EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Sheryl L. Hubbard
Title: Director, Regulatory & Rates

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: STF GWB 4.6

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Accumulated Deferred Income Taxes ("ADIT") – In response to data request GWB1.1, EWAZ does not give any recognition the ADIT balances provided in response to data request GWB1.6 of \$293,862 ADIT credit offset by a \$33,638 ADIT debit for a net ADIT credit of \$260,224.

- i. Please confirm that the above amounts are correct and the ADIT credit would serve to reduce rate base in a future proceeding.
- ii. Please provide the reasons that ratepayers should be deprived of the benefits of an ADIT liability in a future rate proceeding.

- A:
- i. Under Global Water Resources ownership of Willow Valley Water Company, and absent any changes in the balances in the ADIT accounts, the net ADIT credit would be included as a reduction to rate base in future rate proceedings.
 - ii. In an asset sale, deferred income tax asset and liability balances remain with the seller. Unlike a stock purchase transaction, tax attributes like deferred taxes and net operating losses do not convey to the buyer in an asset sale. The customers of the new owner will benefit from the buildup of ADIT liabilities associated with the excess tax depreciation over book depreciation to be recorded in the initial post acquisition years.

ATTACHMENT C

M E M O R A N D U M

TO: THE COMMISSION

FROM: Utilities Division

DATE: June 29, 2001

RE: WATER TASK FORCE OF THE ARIZONA CORPORATION COMMISSION
(DOCKET NO. W-00000C-98-0153)
(DECISION NO. 62993)

On November 3, 2000, the Commission issued Decision No. 62993. This decision approved Staff's recommendations regarding the Commission's Water Task Force. The Commission directed Staff to work with interested parties to develop policy statements, some of which are due by June 30, 2001. Staff has had a number of meetings with interested parties to discuss the issues and resolve parties' concerns on many occasions, as noted below. The reports addressing specific subjects reflect a consensus of the working groups. In only one working group did Staff disagree with a portion of the group's resolution of an issue, which is also discussed below. The reports address the following issues:

Finding of Fact No. 9 from Decision No. 62993 ordered Staff to develop a policy statement regarding Certificates of Convenience and Necessity for water systems. Attachment A to this memorandum is a proposal for this policy developed in a meeting with interested parties.

Finding of Fact No. 11 ordered Staff to develop a policy statement regarding acquisition adjustments and rate of return premiums for water systems. Attachment B to this memorandum is a proposal for this policy, which was developed based on several meetings with interested parties

Finding of Fact No. 29 ordered Staff to develop a policy statement regarding tiered rates. Attachment C to this memorandum is Staff's proposal for this policy, which was developed after several meetings with interested parties.

Finding of Fact No. 31 ordered Staff to develop a policy statement regarding recovery of costs related to the Central Arizona Project. Attachment D is Staff's proposal for this policy, which was developed after several meetings with interested parties. Staff is in agreement with this proposal, except for the portion which deals with the definition of the term "use." The attached policy defines "use" as those methods considered as "use" by the Arizona Department of Water Resources (ADWR). The current regulations of ADWR allow a water company to be in compliance with its requirements as long as the water system uses its CAP water anywhere within the same Active Management Area (AMA) in which the water system is located. This approach is contrary to the position the Commission took in a recent Vail Water Company (Vail) rate case.

THE COMMISSION

June 29, 2001

Page 2

In Decision No. 62450, the Commission approved Vail's cost recovery of its CAP costs with specific mandates regarding Vail's long-term plans for the CAP water. At present Vail is using its CAP water in an "in lieu recharge project". Vail's CAP water is being used by a farm in Red Rock in lieu of the farm using groundwater. Because the farm in Red Rock is in the same AMA (Tucson AMA) as Vail, Vail gets credit for this use by the farm and therefore, is in compliance with ADWR requirements, even though the farm is approximately 60 miles from Vail. Staff believes that the water being recharged in Red Rock will never actually directly benefit the aquifer in Vail and therefore, never benefit the customers of Vail. This was the basis for the Staff recommendations that were adopted by the Commission in Decision No. 62450. The Commission ordered Vail to submit, within 10 years of the Decision, a plan to use its CAP water directly in its certificated area. Decision No. 62450 also ordered Vail to actually begin using its CAP water within its certificated area within 15 years of the Decision.

For these reasons, Staff recommends that the Commission slightly, but significantly, modify the definition of "use" contained in Attachment D by adding the condition that the water system would have to use its CAP water within its certificated area.

Staff recommends that these policy statements be discussed at an Open Meeting at the Commission's convenience.

Deborah R. Scott
Director
Utilities Division

DRS:SMO:

ORIGINATOR: Steven M. Olea

Phoenix Office
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007
(602) 542-4251
(800) 222-7000

Utilities Division
Steven M. Olea - Director

Tucson Office
Arizona Corporation Commission
400 W. Congress, Ste. 218
Tucson, AZ 85701
(520) 628-6550
(800) 535-0148

Electric Gas Telephone Water / Sewer Consumer Services

Attachment B

Proposed Policy for Class D and E Water System Acquisitions

The purpose of the acquisition policy is to try to encourage acquisition and consolidation of small water utilities operating in the state. For purposes of this policy, small water utilities are limited to Class D and E water utilities, i.e., less than \$250,000 of operating revenue in the most recent calendar year. Acquisition of small water utilities should result in improved water quality and/or service for the customers.

Decision No. 62993, dated November 3, 2000, established six general conditions a water company must meet to qualify for an acquisition adjustment or rate of return premium. Per that Decision, the acquisition incentive may be granted in one of two ways: (1) recovery of an amount paid in excess of the book value of the acquired company's assets (acquisition adjustment), or (2) a rate of return premium, but not both. This policy develops criteria and procedures for determining the amount of acquisition incentive that will be eligible for recovery in rates following acquisition of a small water utility.

The purchase price for a small water utility could exceed the book value of its plant in service, resulting in a positive acquisition adjustment. This policy applies exclusively to positive acquisition adjustments, and negative acquisition adjustments shall not be recognized for rate-making purposes.

In certain cases, a rate of return premium may be allowed instead of an acquisition adjustment. Once the rate of return percentage is determined, a premium amount will increase that percentage. The premium percentage will be allowed in rates for a period of time that the Commission determines is appropriate to provide an acquisition incentive.

Following is the list of six conditions a company must prove by a preponderance of the evidence in order to obtain an acquisition adjustment or rate of return premium in rates, as well as criteria to meet those conditions.

1. The Acquired Company Is A Class D Or E.

- This policy is to be applied to the acquisition of Class D and E water utilities, i.e., those having less than \$250,000 of operating revenue in the most recent calendar year.

1. The Acquisition Will Not Negatively Affect The Viability Of The Acquirer.

- The acquiring company shall provide documentation that satisfactorily demonstrates its continued financial viability subsequent to the acquisition. Staff will not recommend approval of a proposed acquisition that would be potentially detrimental to an acquirer's financial viability.

1. The Acquired System's Customers Will Receive Improved Service In A Reasonable Timeframe.

- The acquiring company shall submit a plan for improving service to the customers of the acquired system. The plan shall include, but not be limited to, a detailed listing of the current violations and deficiencies of the water company to be acquired, as well as the acquirer's proposed solutions and the related costs. Additionally, the plan must also include a proposal for how the rates of the small water utility's customers will be affected. The acquirer's plan should also provide estimated implementation dates for each system or service improvement. A service improvement plan might include, but is not limited to, the following:
 - a. Delivering water to customers that meets the quality standards of the Arizona Department of Environmental Quality ("ADEQ") and the Safe Drinking Water Act.
 - b. Satisfactory resolution of outstanding violations with ADEQ and the Arizona Department of Water Resources ("ADWR").
 - c. Developing a reliable source of water supply.
 - d. Developing appropriate water storage capacity.
 - e. Improved water pressure, either higher or lower, within the distribution system.
 - f. Replacement of inadequate, insufficient, deteriorated, and/or inefficient infrastructure.
 - g. Improving billing procedures, customer complaint resolution, and service response times.

1. The Purchase Price Is Fair And Reasonable (Even Though That Price May Be More Than The Original Cost Less Depreciation Book Value) And Conducted Through An Arm's Length Negotiation.

- One factor that would contribute to recommending an acquisition incentive is if the net plant value is either very small or zero, due to substantially or fully depreciated assets that require replacement. Although the water company assets may reflect zero net book value on the records, the assets in theory still have value due to the fact that they generate a future revenue stream. To determine if the purchase price and resulting acquisition incentive amount is fair and reasonable, Staff's evaluation shall include, but not be limited to, the following criteria:
 - a. The purchase price must be the result of good faith negotiations between the two transacting entities.
 - b. The acquisition must be conducted through an arm's length transaction, and the two parties must not be affiliates as defined by A.A.C. R14-2-801.1.
 - c. Present value of future cash flows.

1. The Recovery Period For The Acquisition Adjustment Should Be For A Specific Minimum Time.

- Staff will evaluate the acquisition adjustment recovery period to be fair and reasonable to both the acquirer, and the customers of the small water utility. The specific recovery period shall be set on a case-by-case basis and shall be consistent with the period over which customers are expected to benefit, as well as mitigate the impact of cost recovery on rates.
- If a rate of return premium is sought by the acquiring company, Staff will determine the premium percentage and recovery period on a case-by-case basis. Recovery via the rate of return premium will be calculated to recoup only the excess of the purchase price over the book value of the plant in service.

1. The Acquisition Is In The Public Interest

Staff will investigate the acquirer's compliance history with the ADEQ and the ADWR to determine if it is a fit and proper entity to acquire a small water utility. Acquisition incentives will not be granted to entities that are currently in violation of rules set forth by ADEQ and/or ADWR.

The acquisition of a small water utility would comply with the standard of public interest if the above detailed five conditions are met, and no ADEQ and/or ADWR rule violations are pending. Additionally, the following circumstances may further demonstrate how an acquisition could be in the public interest:

- The small water utility is insolvent, defined as "unable or having ceased to pay debts as they fall due in the usual course of business".
- The small water utility will have increased opportunities to obtain short-term financing as a result of the acquisition. This will enable the company to make improvements to, and correct deficiencies within its water system that would enable it to serve water that meets the quality standards set forth in the Safe Drinking Water Act.
- Short-term and long-term cost savings can be demonstrated as a result of the acquisition, as well as efficiencies and economies of scale.
- As a result of the acquisition, delinquent remittance of transaction privilege tax and/or property tax by the small water utility to the Arizona Department of Revenue will be satisfied.

PROPOSED PROCEDURE

Once the two entities enter into a transfer/purchase agreement, they will submit a joint application to the Commission pursuant to Arizona Administrative Code Section R14-2-103. The joint application should include the following information:

- a. A Commission approved rate application for water companies with annual gross operating revenues of less than \$250,000 for the small water utility to be acquired as of the most recent fiscal year end, or all the information required in such a rate case application along with a request for a Commission accounting order delineating how the acquisition incentive will be treated.
- b. Financial statements of the acquirer as of the most recent fiscal year end.
- c. Disclosure of transaction as either an asset purchase and Certificate of Convenience and Necessity transfer, or stock purchase.

- d. A copy of the purchase agreement/sale document including the proposed purchase price.
- e. A detailed explanation and supporting evidence to demonstrate how the acquisition meets the six conditions to be eligible for recovery of an acquisition adjustment in rates.
- f. A list and explanation of current known deficiencies of the system to be acquired as well as the acquirer's proposed solutions to remedy the deficiencies, along with the costs, and timeframe for implementing the solutions.
- g. Reconstruction Cost New (RCN) for the small water utility to be acquired or adequate information for an RCN study to be performed.
- h. A detailed calculation of the proposed acquisition adjustment requested to be eligible for recovery in rates, a proposal for its method of recovery, and a calculation of its effect on rates.

Upon submission of the application, Staff will analyze the documentation to determine whether the acquisition meets the six conditions identified in Decision No. 62993, by:

1. Analyzing the company's financial information to determine that it is a Class D or E water utility.
2. Assessing the acquiring entity's financial resources to determine if sufficient financial resources are available to acquire a small water utility without jeopardizing the acquirer's good financial standing.
3. Evaluating the acquirer's proposed actions to assess whether customers of the acquired small water utility will receive improved service within a reasonable timeframe.
4. Evaluating the original cost of the existing plant assets on the acquired utility's books, as well as RCN amounts. Staff will then compare those two amounts with the proposed purchase price to determine if the purchase price is fair and reasonable; if the purchase price was negotiated, and if the sale will be conducted, through an arms length transaction; and what amount of acquisition adjustment or rate of return premium, if any, will be allowed.
5. Classifying the acquisition incentive as either a regulatory asset (acquisition adjustment) or a rate of return premium, to be recovered over a specific time.
6. Reviewing the documentation provided in response to the five conditions set forth, as well as other potential benefits identified by the acquirer and determine if the acquisition meets the criteria of public interest. Staff will also evaluate whether the acquirer is a "fit and proper" entity to purchase a small water utility.
7. Requesting and analyzing other information/data that Staff and/or the Commission deems necessary for a particular case.

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ORIGINAL

MEMORANDUM
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0000135266

TO: Docket Control Center

FROM: Steven M. Olea
Director
Utilities Division

2012 MAR 19 P 2:44

AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

MAR 19 2012

DOCKETED BY

MM

DATE: March 19, 2012

RE: STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS PROPERTY THROUGHOUT THE STATE OF ARIZONA. DOCKET NOS. SW-20445A-09-0077, W-02451A-09-0078, W-01732A-09-0079, W-20446A-09-0080, W-02450A-09-0081 AND W-01212A-09-0082

Attached is the Staff Report, pursuant to the compliance filing ordered in the above-named docket, resulting from the series of workshops held in Docket No. W-00000C-06-0149, Generic Evaluation of the Regulator Impacts from the Use of Non-Traditional Financing Arrangements by Water Utilities and Their Affiliates.¹

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction ("AFUDC") rate on qualified plant replacements² for up to 24 months³ after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisition premiums would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.

¹ Staff will prepare separate reports to address distribution system improvement charge ("DSIC") and the treatment of income taxation for S corporations and limited liability companies.

² At a minimum qualified plant would need to be found used and useful during the 24-month period.

³ Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

4. That monies received pursuant to Infrastructure Coordination and Financing Agreements ("ICFAs") continue to be treated as Contributions in Aid of Construction ("CIAC"). This recommendation may be modified as a result of the pending review of Global's ICFAs by an independent Certified Public Accountant firm.

SMO:GWB:kdh

Originator: Gerald W. Becker

Service List for: Global Water – Palo Verde Utilities Company et al
Docket Nos. SW-20445A-09-0077 et al.

Mr. Timothy J. Sabo, Esq.
Roshka DeWulf & Patten, PLC
One Arizona Center
400 E. Van Buren Ste. 800
Phoenix, Arizona 85004

Mr. Dan Pozefsky
Chief Counsel, RUCO
1110 W. Washington Street, Suite 220
Phoenix, Arizona 85007

Mr. Michael T. Hallam
Lewis & Roca
40 N. Central Avenue, Suite 1900
Phoenix, Arizona 85004

Mr. Garry D. Hays
Law Offices of Garry D. Hays
1702 E. Highland Avenue, Suite 204
Phoenix, Arizona 85016

Mr. Jeffrey W. Crockett, Esq.
Brownstein, Hyatt, Farber & Schreck
40 N. Central Avenue, 14th Floor
Phoenix, Arizona 85004

Mr. Court Rich
6613 N. Scottsdale Road, Suite 200
Scottsdale, Arizona 85250

Mr. Rick Fernandez
25849 W. Burgess Lane
Buckeye, Arizona 85326

Mr. Greg Patterson
916 W. Adams Street, Suite 3
Phoenix, Arizona 85007

Mr. Paul Walker
3131 E. Camelback Road, Suite 200
Phoenix, Arizona 85016

Mr. Gary Yaquinto
2100 N. Central Avenue, Suite 210
Phoenix, Arizona 85004

Mr. Bryan O'Reilly
50 S. Jones Boulevard, Suite 1
Las Vegas, Nevada 89107

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

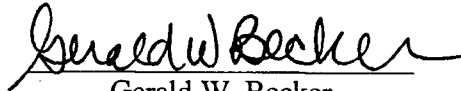
**STAFF REPORT FOR COMPLIANCE FILING IN THE MATTER OF THE
APPLICATION OF GLOBAL WATER FOR THE ESTABLISHMENT OF JUST AND
REASONABLE RATES AND CHARGES FOR UTILITY SERVICE DESIGNED TO
REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS
PROPERTY THROUGHOUT THE STATE OF ARIZONA**

**DOCKET NOS. SW-20445A-09-0077
W-02451A-09-0078
W-01732A-09-0079
W-20446A-09-0080
W-02450A-09-0081
W-01212A-09-0082**

MARCH 19, 2012

STAFF ACKNOWLEDGMENT

Staff report for compliance filing in the matter of the application of Global Water for the establishment of just and reasonable rates and charges for utility service designed to realize a reasonable rate of return on the fair value of its property throughout the state of Arizona was the responsibility of the Staff members listed below.

A handwritten signature in cursive script, reading "Gerald W. Becker". The signature is written in dark ink and is positioned above a horizontal line.

Gerald W. Becker
Public Utilities Analyst V

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EXCERPT FROM DECISION NO 71878	ATTACHMENT A
--------------------------------------	--------------

Introduction

On February 20, 2009, Global Water - Palo Verde Utilities Company ; Valencia Water Company - Greater Buckeye Division ; Willow Valley Water Company, Inc.; Global Water - Santa Cruz Water Company; Water Utility of Greater Tonopah, Inc.; and Valencia Water Company – Town Division, (collectively “Global” or “Company”) filed with the Arizona Corporation Commission (“Commission”) applications in the above-captioned dockets seeking increases in their respective permanent base rates and other associated charges. Decision No. 71878 arose from that proceeding in Docket Nos. SW-20445A-09-0077 et al.

In Decision No. 71878, the Commission approved Staff’s recommendation that approximately \$60.1 million of monies received under Infrastructure Coordination and Financing Agreements (“ICFAs”) be imputed as Contributions in Aid of Construction (“CIAC”). Decision No. 71878 further ordered that a generic investigation be commenced which looks at how best to achieve the Commission’s objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. The workshop was to address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission’s objectives in this regard.

To comply with Decision No. 71878, Staff held a series of workshops. The workshop dates and subject matters are shown below:

November 1, 2010 – Introduction and timelines.

January 14, 2011 – Distribution System Improvement Charges (“DSICs”)

February 25, 2011 – Acquisition Adjustments and Rate of Return Premiums.

March 25, 2011- Imputed Income Tax for S Corporations and certain LLCs

June 16, 2011 – Generalized Cost of Equity. See also Docket No. 08-0149,

June 24, 2011 – ICFAs

November 4, 2011 – Cost of Equity, ICFAs, and Conclude Workshops

Purpose of the Workshops

The purpose of the workshops was to comply with the requirements of Decision No. 71878¹ as shown on Attachment A.

¹ Decision No 71878, 89 at 9-20.

Staff Analysis

Staff attended the workshops and has reviewed the filings of the various participants. In this filing Staff's comments are limited to its recommendations on:

1. Post-in-Service Allowance for Funds Used During Construction ("AFUDC") and Deferred Depreciation
2. Acquisition premiums and/or rate of return premiums.
3. A possible mechanism to capture the effects of untimely delays in the processing of a rate case.
4. Continued treatment of ICFAs per Decision No. 71878 pending results of an independent audit.

Post-in-Service AFUDC and Deferred Depreciation

At one of the workshops, participants expressed concern regarding the inability to earn an awarded Rate of Return ("ROR") due to the carrying costs incurred between the time when Construction Work in Progress ("CWIP") is transferred to Utility Plant in Service ("UPIS") and considered for recognition in rate bases. This occurs because the recording of AFUDC ceases when CWIP is transferred to UPIS.

Under present treatment, utilities record projects in the CWIP accounts and are allowed to record AFUDC on those balances using a rate that equals the utility's cost of capital. Upon transferring the cost of the completed project from CWIP to UPIS, the recording of AFUDC ceases and the utility begins depreciating the asset. During the interim period between the transfer from CWIP to UPIS and the date when the asset may be recognized in rate base, the utility bears the carrying costs of the asset which are unavoidable and unrecoverable under the present regulatory process. Once a project is completed, it is transferred to UPIS.

Staff recommends that some consideration be given to mitigating the effects of carrying costs of net plant additions between rate proceedings. Under optimal conditions, a utility would transfer plant to UPIS concurrently with filing a rate case which would require up to 12 months to process. In addition, Staff prefers 12 months of data after a Company has received new rates before it can file another rate case. Realistically, the utility will bear the carrying costs of the incremental net plant additions during the interim period which is at least 24 months. While the utility is technically not entitled to earn on that incremental plant absent a fair value determination, Staff recommends that some consideration be given to mitigate effects of associated carrying costs which could be significant. Staff recommends the deferral of post-in-service AFUDC for a period of up to 24 months to mitigate the effect of regulatory lag.

Staff also recognizes that a utility records depreciation expense from the date that the asset is placed into service. If this occurs during or prior to the end of the test year in a rate proceeding, the utility incurs depreciation expense but has no opportunity to recover it. Similar to the reason associated with regulatory lag discussed more fully above regarding post-in-service

AFUDC, Staff further recommends that depreciation expense be deferred for a period of up to 24 months to mitigate the effects of regulatory lag. (The precise entries to effect this would need to be determined.)

The deferral of AFUDC and depreciation would allow a Company to request recovery of both amounts, which it would not normally be allowed to do absent an approved deferral.

Acquisition Premiums

Some participants cite two instances when Staff recommended and the Commission approved an acquisition premium. In researching this issue, there are two cases to consider which may serve to clarify the record.

1. Paradise Valley Water Company ("PVWC")/Mummy Mountain Water Company ("Mummy Mountain") – In this proceeding, Docket Nos. W-01342A-98-0678 and W-01303A-98-0678, Decision No. 61307, the owners of Mummy Mountain sold their system for approximately \$150,000 which included a \$40,000 payment to the sellers, approximately \$47,000 forgiveness of debt for the utility service owed by the seller to the buyer (PVWC), \$32,000 of property taxes owed by the seller but to be paid by the buyer, and administrative costs of \$20,000 associated with the sale. Unfortunately, the record is silent regarding the net book value of the assets transferred to PVWC, and Mummy Mountain's most recent rate case, Docket No. W-01342A-91-0224, Decision No. 57877, is too stale to provide reliable information regarding an appropriate valuation of the business. Staff is therefore unable to ascertain the existence, or lack thereof, of an acquisition premium associated with this transaction.
2. The sale of the "McClain systems" to Northern and Southern Sunrise Water Companies – Staff reviewed the record underlying Decision Nos. 68412 and 68826. Dated January 23, 2006, Decision No. 68412 was a rate case which approved a negative goodwill of \$52,141 for substandard operating conditions of the McClain systems. Dated June 29, 2006, Decision No. 68826 approved the transfer of the "McClain systems" to Northern and Southern Sunrise Water Companies and approved acquisition costs of \$300,000, including \$100,000 for reorganization, bankruptcy and other costs, \$100,000 for Commission related activities, and \$100,000 for transition costs such as support for an interim operator, capitalized labor costs, etc.² Thus, Staff could not find any evidence of the Commission granting recovery of a true acquisition premium, although Staff also notes that it is aware of few requests by utilities to recover an acquisition premium.

While a policy of granting acquisition premiums has the theoretical potential to encourage healthy utilities to acquire non-viable utilities, it also has the undesirable effect of providing owners an incentive to underperform and become non-viable by design to place their utilities in a position to become a lucrative acquisition target. Thus, establishing a general policy

² Decision No 68826, Findings of Fact, paragraph 47.

to grant acquisition premiums can have undesirable as well as desirable attributes. Accordingly, acquisition premiums are better considered on a case-by-case basis.

Staff concludes that the granting of acquisition premiums should be withheld at the time the proposed sale/transfer is being considered and that authority should be granted to allow potential recovery upon the acquiring utility meeting specified conditions such as 1) demonstrating clear, quantifiable and substantial benefits realized by ratepayers that are unlikely to have been realized had the transaction not occurred; 2) balancing the value of the realized benefits against the rate impact; and 3) granting any recovery of an acquisition premium over an extended time and requiring continued recovery to be re-justified in subsequent rate proceedings to encourage continuous delivery of improved, quality service.

Rate of Return Premiums

Rate of return premiums may be an alternative to acquisition premiums for encouraging healthy utilities to acquire non-viable utilities. However, unlike acquisition adjustments, it does not present the potential to encourage dysfunctional behavior by operators to intentionally underperform, and accordingly, it is generally a preferred mechanism. Rate of return premiums also have a benefit of inherently including a provision for revisiting the appropriateness of its continuation in each rate case. Staff concludes that the granting of rate of return premiums can be an appropriate mechanism for encouraging the acquisition of non-viable water companies under certain conditions. Similar to the granting of an acquisition premium as discussed above, granting of rate of return premiums should be predicated on the attainment of demonstrable, quantifiable and realized benefits to ratepayers that would not have occurred had the transaction not occurred. Rate of return premiums might be predicated on the attainment of certain operational goals and/or implementation of certain best management practices and/or other metrics.

Untimely Delays

The Arizona Administrative Code prescribes certain times for the processing of rate cases. The time lines vary from 360 days³ for Class A and B utilities to 120 days for Class E utilities. In some instances, a case may experience delays for which an applicant is not culpable due to its actions or inactions. To the extent that a proposed rate increase is delayed, the applicant experiences a permanent loss of the incremental revenues that are ultimately approved. To mitigate the effect of foregone revenues under the aforementioned circumstances, Staff recommends the establishment of a deferral mechanism on a case by case basis to capture the estimated effect of untimely delays in the processing of rate applications. Such a mechanism would be subject to additional analysis in subsequent rate proceedings.

³ Time lines are from the "Sufficiency Date" when Staff determines that an application has met (initial) filing requirements.

Continued Treatment of ICFAs Consistent with Decision No 71878

At the time of this report, an audit of the ICFA monies received by Global and its parent under ICFAs through December 31, 2008, is underway. Staff will file a supplemental report upon receipt and review of the report from the independent audit firm.

Conclusions and Recommendations

Staff recommends:

1. Consideration of authorizing utilities to record and defer depreciation and a cost of money using an Allowance For Funds Used During Construction ("AFUDC") rate on qualified plant replacements⁴ for up to 24 months⁵ after the in-service date to mitigate the effects of regulatory lag.
2. Consideration of allowing acquisition premiums and/or a premium on the rate of return on a case by case basis and subject to certain conditions, in those cases where the impacts may be offset to some extent by the effects of operational improvements. If granted, acquisitions premium would be subject to review and re-justification in future proceedings.
3. Consideration of establishing a mechanism to recognize the effect of delays in the processing of rate cases when applicant is not culpable for those delays.
4. That monies received pursuant to Infrastructure Coordination and Financing Agreements ("ICFAs") continue to be treated as Contributions in Aid of Construction ("CIAC"). This recommendation may be modified as a result of the pending review of Global's ICFAs by an independent Certified Public Accountant firm.

⁴ At a minimum qualified plant would need to be found use and useful during the 24-month period.

⁵ Terminates before 24 months if rates become effective that include the qualified plant in rate base in the 24-month period.

Decision No. 71878:

IT IS FURTHER ORDERED that a generic investigation shall be commenced which looks at how best to achieve the Commission's objectives with regard to encouraging the acquisition of troubled water companies and the development of regional infrastructure where appropriate. As part of this proceeding, the workshop shall address whether ICFAs, or other mechanisms, if properly segregated and accounted for, could be utilized to finance the actual acquisition of troubled water companies, and a portion of the carrying costs associated with the unused water and wastewater facilities or infrastructure determined to meet the Commission's objectives in this regard. Therefore, we will require Staff to notice and facilitate, and Global to participate in stakeholder workshops designed to address these issues, and make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future rate cases. The workshops shall be noticed and held in the existing Generic Docket.

IT IS FURTHER ORDERED that Staff shall, within 30 days, provide notice to the parties to the Generic Docket, and to other stakeholders, of new workshops in Docket No. W-00000C-06-0149, for stakeholder workshops designed to address the issues set forth in Findings of Fact No. 84. Following the conclusion of the workshops, Staff shall, within 90 days, make recommendations to the Commission on the issues discussed in the workshops, including whether it is appropriate to adopt the recommendations in the next Global Utility rate case, as well as other future water cases.

IT IS FURTHER ORDERED that if the Commission workshop results in future treatment of ICFAs that is different than the result in this case, the Applicants may request review of the ICFAs subject to this Order in a future rate case for setting prospective rates consistent with the recommendations adopted from the future workshop process.

ATTACHMENT D

Tolleson to get \$4.3M settlement in water treatment plant dispute

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Submitted by Emily Toepfer on Fri, 06/12/2015 - 12:00am

The Tolleson City Council on Tuesday approved a \$4.3 million settlement with one of its Wastewater Treatment Plant users following a yearlong dispute over upgrades.

EPCOR, a private utility company that provides water and wastewater services to Sun City customers, has two weeks to pay Tolleson under the agreement.

Tolleson's plant, 9501 W. Pima Road in Phoenix, has been in operation since 1968 and has the capacity to treat 8.1 million gallons of water per day.

The city has the potential to treat up to 2.1 million gallons per day, while EPCOR contracts for 5.2 million gallons and a third user, JBS Packerland-Tolleson, contracts for 800,000 gallons.

EPCOR has had a service agreement with Tolleson for wastewater treatment since June 1985, which states the company pays its share of operations and maintenance of equipment and facilities.

Tolleson started planning upgrades to the plant in 2010 in order to treat high levels of ammonia under the terms of its Arizona Pollutant Discharge Elimination System Permit, but EPCOR later refused to pay its 63 percent share of the cost, according to the claim.

The dispute centered on each party's interpretation of provisions in the agreement that pertained to identifying capital projects and determining EPCOR's share of costs, the claim states.

Tolleson filed a complaint against EPCOR in July 2014, and the company counterclaimed five months later.

In an effort to resolve the matter, the parties negotiated a fourth amendment to their service agreement, which better defined the rights and responsibilities of the parties, said Rick Hood, an attorney with Gust Rosenfeld, which represents Tolleson.

It also detailed the procedures by which studies are made and how future capital projects and engineers will be selected. In the end, Tolleson will have the final say, although a dispute resolution process was also established in the agreement.

"If there's a problem with a study or project, it will become known earlier, and through the dispute resolution process, it will be taken care of one way or the other before we get to the point where the city has put it out for bid, selected their engineer and began to incur costs," Hood said.

The total project cost through April was \$7.1 million. At the request of JBS, it also included adding capacity for another 130,000 gallons per day.

EPCOR agreed to pay its share at the same percent on any remaining balance for the ammonia project not yet billed.

Currently, the company uses only 3.2 million gallons per day of its 5.2-million-gallon contracted capacity, and the new agreement states it can reduce its capacity by up to 1.5 million gallons per day.

In that case, Tolleson would likely lower the plant's total capacity to 6.6 million gallons per day to reduce the size of future capital projects, the agreement states.

With the settlement approved, the lawsuit will be dismissed with prejudice and each party will pay its own legal fees.

"Going forward, it will strengthen our relationship with one of our partners, and we look forward to continuing to grow together," Tolleson City Manager Reyes Medrano Jr. said.

Previous plant dispute

It wasn't the first time the city sued a partner over the plant. Tolleson filed a \$26 million claim in 2007 when Peoria discontinued use of the wastewater treatment plant and refused to pay its share of renovations.

At the time, \$42 million in upgrades were planned to bring the plant up to code standards. When Peoria decided not to participate, it cost \$25,000 to have new designs done, city officials said at the time.

An agreement was reached in April 2009 that required Peoria to pay Tolleson \$8.5 million — \$1.1 million in unpaid fees and \$7.4 million for the remainder of the litigation in three installments.

Upgrades included anaerobic digesters, solids thickening and solids dewatering systems, the digester gas system and boilers, ancillary solids equipment and piping.

Tolleson finished the renovations in March 2011, and they should last another 20 years, officials said.

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Phoenix water company overcharged city \$2.7M, audit claims



Betty Reid, The Republic | azcentral.com 11:27 a.m. MST August 22, 2014



(Photo: Getty Images)

A city audit claims a north Phoenix private water and wastewater provider overcharged the city \$2.7 million over five years and also passed on an unnecessary tax to the city.

Officials with EPCOR Water, which sells water to Phoenix to serve Anthem Phoenix West, dispute some of the audit's findings and are working with the city to settle others.

Phoenix directly provides water to the majority of its residents. However, in this case, Phoenix buys water from EPCOR, which allows the city to use its pipes to serve residents.

Councilwoman Thelda Williams called the Phoenix audit results serious. She said Phoenix needs to double check any cost imposed by EPCOR, which also has caught flak recently from other areas of the Valley for its rates.

"I think the city needs to receive reimbursement, and we will monitor the situation closely," Williams said.



AZCENTRAL

Water rates vary in Phoenix metro area

(<http://www.azcentral.com/story/news/local/surprise/2014/04/16/water-rates-vary-phoenix-metro-area/7751735/>)

The audit, released in June, examined services delivered from 2008 to 2013 to Anthem Phoenix West, west of the Interstate 17 and Anthem Way.

The Phoenix audit said the city bought about 1.9 millions of gallons of water over five years. The city paid EPCOR about \$6 million for the water and wastewater services.

The audit included several findings:

- The city auditors believe it overpaid for water lost through leaks and breaks. It's EPCOR's responsibility to fix those leaks, officials said. However, Phoenix should have monitored the water loss, according to the audit.
- EPCOR taxed Phoenix for water resold to the residents. However, the city is exempt from the tax.
- EPCOR also raised fees — an increase auditors believe EPCOR failed to justify. This amounts to about \$2.7 million.

EPCOR officials said they are working with the city to resolve some of the issues.

The city has accepted an adjustment of \$5,387 for water-loss charges, city officials said.

The company is waiting for a refund from the Arizona Department of Revenue, which collected the tax from EPCOR, said Jeff Stuck, EPCOR Water director of operation. City officials said EPCOR agreed to seek the refund and repay \$1,214.

As for the rate increase, Stuck said the Arizona Corporation Commission approved it, so EPCOR had the right to charge the city. He said Phoenix should work with the commission to address the rate increase.



AZCENTRAL

Sun City, Sun City West could see increased wastewater rates

(<http://www.azcentral.com/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/>)

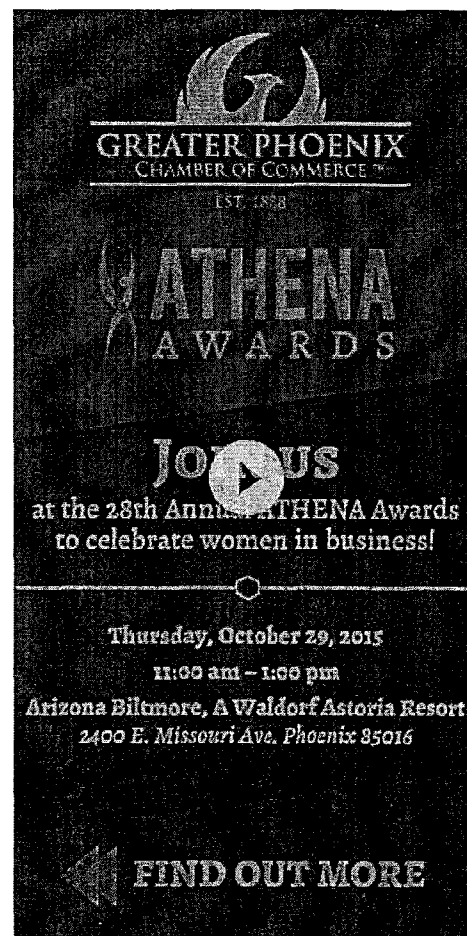
City officials had not raised water rates for two consecutive years.

However, the latest budget called for a new tax, which will cost an average homeowner an extra \$1.50 per month. Phoenix would base the tax on meter size, not water usage.

EPCOR provides water and sewer services to other parts of the Valley.

It has been under fire recently after [Sun City West Valley customers complained about its water and wastewater rates](http://story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/) ([/story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/](http://story/news/local/surprise/2014/08/12/sun-city-sun-city-west-wastewater-rates/13953033/)). Earlier this year, the Arizona Corporation Commission, which regulates utilities in the state, received complaint letters as well as petitions with thousands of signatures from homeowners requesting a review of rates.

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ATTACHMENT E

Accounting for Public Utilities

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basis that they were not considered used or useful in providing utility service. However, it may be argued that no relief results in an unfair burden to the utility in those situations where project decisions were initially based on good judgment to supply ratepayers with adequate service. Where prudence is demonstrated on the part of the utility, commissions often allow a deferral of the loss associated with the cancellation and an amortization to cost of service over some extended future period. (For further discussion, see § 4.04[11][d], below.)

The various rate base components are discussed in detail in the following sections. Because of the complexity and controversy surrounding the working capital component, especially cash working capital, Chapter 5 is devoted to that discussion.

§ 4.04 Items Included in Rate Base

[1] Plant in Service

Plant in service is the most important component of a utility's rate base. This item commonly represents between 95 and 99 percent of the total rate base amount, after a deduction for related accumulated depreciation and amortization. The significance of plant in service is easily understood in light of the tremendous amount of capital invested in the construction of utility facilities. Major expenditures are required for land acquired for construction sites, construction material and supplies, operation of construction-related equipment, and construction-related labor activities. In addition, overhead allocations are required for those general expenses incurred which are, at least in part, due to utility construction (administrative payroll, engineering design, employee pension expense, sales tax, etc.). Furthermore, financing costs are generally capitalized as a component of plant cost during the construction period. In the case of electric power generation from nuclear fuels, the extensive costs of procurement, refinement, enrichment, and fabrication of the fuel are also capitalized as a separate component of the utility plant. Despite being the largest component of the rate base, utility plant is generally one of the less controversial areas in a rate proceeding. However, the prudence of expenditures or the usefulness of plant if large amounts of excess capacity exist is

sometimes challenged. The amount expended during construction also may be challenged.

[2] Acquisition Adjustments

The general rule related to the acquisition of utility plant previously used in the utility function is that the rate base component for the plant includes only the original cost of the property to the first owner devoting the property to public service. Therefore, if a utility acquires major fixed assets (i.e., an operating unit or system) from another utility by purchase, merger, consolidation, liquidation, or otherwise at a price in excess of the seller's original cost (net of accumulated depreciation), the addition to the acquiring utility's rate base reflecting the acquired assets may be limited to the undepreciated original purchase price. The excess amount paid is referred to as an acquisition adjustment and is placed in a separate account to be treated for ratemaking purposes as so authorized by the jurisdictional regulatory commission. For example, electric utilities subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) must place acquisition adjustment balances in Account 114—"Electric Plant Acquisition Adjustments." Instructions to the FERC's Uniform System of Accounts call for amortization of the adjustments to Account 406, "Amortization of Electric Plant Acquisition Adjustments," with amounts includible in operating expenses, pursuant to approval or order of the Commission. If the Commission has not approved the use of Account 406, the amortization is to be recorded in Account 425, "Miscellaneous Amortization" (below-the-line), over a period not longer than the estimated remaining life of the related properties (or 15 years in the case of land-related adjustments). See Chapter 11 for a detailed discussion of the Uniform Systems of Accounts.

The necessity of this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the acquisition and merger period of the 1920s and 1930s. (See Chapter 2 for a detailed discussion.) Through the process of acquiring utility assets or entire utility companies at prices in excess of depreciated cost, purchasing utilities were able to write up their basis in plant assets. If these purchase prices were in excess of the "value" of the property, the utility was able to inflate its rate base artificially. This situation often occurred if the purchase was from an affiliated

company under the ownership of a common utility holding company. By effectively trading properties, commonly owned utilities were able to inflate their rate bases through transactions that lacked any economic substance.

The outgrowth of this situation was a general consensus among regulators that utility customers should not pay on an amount in excess of the cost when property was originally devoted to public service, since any excess represented only a change in ownership without any increase in the service function to utility ratepayers. By accounting for acquisition adjustments separately from plant in service, these excess costs could be better controlled by regulatory authorities as to their ultimate disposition.

Two basic questions surround the ratemaking treatment of the various amounts included in the acquisition adjustments account:

- (1) should any of the amounts be accorded rate base treatment; and
- (2) should the amortization of any of these balances be considered in cost of service?

Rate base and cost of service treatment are often inconsistent when commissions deal with the acquisition adjustments issue.

Acquisition adjustments are sometimes excluded from the rate base and amortized below-the-line under the premise that these excess costs provide no additional benefit to ratepayers and that to allow these investment dollars to earn a return or to allow recovery through cost of service treatment may unjustly penalize consumers. Rate base treatment and/or cost of service treatment, however, has been allowed by various regulatory commissions under a variety of circumstances. The reasons most commonly cited for allowing rate base and/or cost of service treatment of acquisition adjustments are as follows:

- (1) when acquisitions represent an essential or desirable part of an integration of facilities program devoted to serving the public better;
- (2) when acquisitions are clearly in the public interest, because operating efficiencies offset the excess price over net original cost; and
- (3) when acquisitions are determined to involve arm's-length bargaining.

A substantial number of cases exist where rate base and/or cost of service treatment has been allowed as a result of satisfying one or more of the criteria listed above. For example, in 1969, the Tennessee Public Service Commission allowed both rate base and cost of service treatment for acquisition adjustments of United Inter-Mountain Telephone Company, where the acquisitions were found to be in the best interest of the public and not for the purpose of inflating the rate base.⁴ In the 1955 case of *Arlington County v. Virginia Electric Power Co.*,⁵ the Virginia Supreme Court of Appeals ruled that the Virginia State Corporation Commission had properly allowed both rate base and cost of service treatment for an amount paid at arm's-length bargaining in excess of original cost when first devoted to public use. When the Louisiana Public Service Commission allowed Louisiana Power and Light Company rate base and cost of service treatment for certain acquisition adjustments, the Louisiana Commission relied upon several of the criteria previously discussed. To quote from the Louisiana Commission's 1946 decision:

"The owners of a public utility are entitled to earn and receive a fair rate of return upon the money prudently invested in property used and useful in rendering public service. Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between nonassociated buyer and seller, if the excess was necessary for the integration of the property into a larger and more efficient system, and if the purchase necessitating the excess did or reasonably should have resulted in public benefit by improvement of service to customers or in lowered rates or both better service and lowered rates. This integration cost or excess of purchase price over original cost termed in prescribed system of accounts as 'Utility Plant Acquisition Adjustments' should remain a part of the prudent investment during the life of the physical property to which it was applied, and its extinguishment from the investment when and if required by the Commission, should be accomplished by amortization through annual charges to Operating Revenue Deductions during the life of the

⁴ Re United Inter-Mountain Tel Co, 79 PUR3d 499 (Tenn 1969).

⁵ 8 PUR3d 120 (Va 1955).

property remaining after the date of the purchase which created the excess.”⁶

While the FERC generally excludes acquisition adjustments from rate base treatment, it will permit the inclusion of these balances in the rate base for allocation purposes only (that is, allocating utility assets between jurisdictional and nonjurisdictional rate base) where the related state regulatory commission allows rate base treatment of the adjustments.

As a general rule, when acquisition adjustments are allowed in the rate base, amortization to cost of service is also allowed, and, where a return is not allowed, amortization is required below-the-line. Some regulatory commissions, however, have allowed inconsistent treatment principally as a means of sharing the costs associated with acquisition adjustments between investors and ratepayers. For example, the North Carolina Utilities Commission allowed Duke Power Company to amortize certain acquisition adjustment balances to cost of service but disallowed rate base treatment.⁷ On the other side, the Utah Public Service Commission allowed certain unamortized acquisition adjustments in the rate base of Utah Power and Light Company but required that the amortization flow below-the-line to “miscellaneous amortization.”⁸

Using a different approach, the Kansas State Corporation Commission allowed Western Resources, Inc. (formerly Kansas Power and Light Company) the opportunity to recover an acquisition premium (as well as a return on the premium) incurred in connection with its acquisition of Kansas Gas and Electric Company in 1992. Rather than permitting rate base treatment and amortization in cost of service, the Commission allowed Western Resources to retain part of the anticipated cost savings to be realized in future years from merging the operations of the two companies.⁹

On occasion, a utility may purchase used plant at a price lower than the net book value in the hands of the selling utility. These transactions are generally accounted for by a debit to plant in service for the net original cost with a credit to the acquisition adjustment

⁶ Re Louisiana Power and Light, 65 PUR (NS) 23 (La 1946).

⁷ Re Duke Power Co, 26 PUR4th 241 (NC 1978).

⁸ Re Utah Power and Light, 48 PUR3d 153 (Utah 1962).

⁹ Re Kansas Power & Light, 127 PUR4th 201 (Kan 1991).

account for the deficiency. In these cases, a similar question arises regarding the handling of the credit acquisition adjustments for ratemaking purposes. The regulatory commissions and courts have varied in their opinions as to the appropriate treatment of these balances and have not necessarily followed the same reasoning as followed regarding ratemaking treatment for debit adjustments. In general, credit balances are used to reduce the rate base and are also amortized above-the-line (as a reduction of operating expenses) with what appears to be greater frequency than corresponding treatment for debit adjustments. Consistent reasoning regarding the treatment of debit and credit adjustments, however, does exist and is exemplified in a 1973 order of the Vermont Public Service Board in a rate proceeding involving Vermont Gas Systems, Incorporated:

“ ‘Original cost’ relates to the cost incurred by the utility purchasing the facility, not the original cost of a prior owner. Assuming prudent investment, the stockholders should be allowed to earn a return on their actual ‘out-of-pocket’ investment; the fact that the marketplace may place a higher or lower valuation on the property does not affect the amount of the actual price paid by petitioner.”¹⁰ (Emphasis added.)

The basis for disallowing rate base treatment of acquisition adjustments is the assumption that the rate base should include only the net original cost to the utility first devoting the property to public use. In cases where used property is purchased from non-utility sellers, there is no acquisition adjustment, since the property has not previously been utilized in providing utility services. In these cases, net original cost is the purchase price paid by the acquiring utility. A question that has occasionally been raised concerns the purchase of used property from another utility (rate regulated enterprise) not involved in the same utility operation and therefore subject to a different scheme of regulation. While this issue has not been raised often, it appears that in most cases the general rule is interpreted broadly to encompass the first regulated enterprise of any type devoting plant to public service. A court case related to this matter involved the purchase of electric transmission lines by Montana Power Company from Chicago, Milwaukee, St. Paul & Pacific Railroad. In this 1979 case, the U.S. Court of Appeals ruled that the property had previously been devoted to public

¹⁰ Re Vermont Gas Sys, 100 PUR3d 209 (Vt 1973).

use by a regulated enterprise and that only the original cost to the original user should therefore be allowed in rate base.¹¹

[3] Accumulated Depreciation and Amortization

Recovery of the dollars invested in plant in service is permitted over the plant's estimated useful life by a systematic depreciation charge to cost of service, normally on a straight-line basis with an equal portion of the original cost investment (net of estimated salvage less removal costs) recovered in each period over the estimated service life of the related fixed assets. The subject of utility depreciation accounting is examined in detail in Chapter 6.

Deduction of the reserves accumulated for annual depreciation and amortization charges from a utility's rate base is an accepted principle of rate base development, with the reserve balances generally calculated on the same basis as that used for determining rate base plant in service (13-month average, year-end, etc.). Theoretically, the accumulated reserves have already been collected from utility customers through the cost of service treatment for depreciation and the resulting revenue requirements generated. Deducting accumulated reserves from the rate base prohibits the utility from earning a further return on costs that have been recovered and also avoids the confusion of attempting to equate net plant in service (unamortized cost investment) with any measure of current "value" of the property. It does not matter if net plant in service is not an accurate measure of the property's current value (and it most likely is not). Accumulated depreciation in investment cost jurisdictions is not designed to force net plant to equal current value but instead is simply used to reduce the rate base for that portion of plant investment and net salvage already recouped through rates.

For regulatory jurisdictions following the fair value approach to rate base development, determination of the appropriate accumulated depreciation balance is the subject of considerable controversy, with the specific techniques employed varying widely among the different regulatory commissions. With this approach, accumulated depreciation is more closely associated with an attempt to measure the "current value" of utility plant, with a corresponding recognition of the value that has been "used" since the plant was

¹¹ Montana Power Co v Federal Energy Regulatory Commn, 31 PUR4th 191 (9th Cir 1979).

placed in service. Examples of the methods employed for determining depreciation reserves under the fair value concept include:

- (1) determining the fair value of gross plant and then attempting to calculate the necessary depreciation reserve to reflect the cumulative loss in value in current dollars; and
- (2) determining the fair value of gross plant and then calculating the related depreciation reserve by multiplying gross plant by the same percentage as the ratio of original cost accumulated depreciation to gross original cost plant.

Concepts for estimating fair value depreciation are discussed in more detail in Chapter 6.

Sometimes, depreciation reserves are determined to be either too small or too large, usually as a result of either the experience being different than what was expected or the modification of future expectations. In those cases where the reserves are found to be too small, the reserve difference is commonly the result of two possible factors. Earlier estimates of service lives may have been too long as a result of changing circumstances, such as current technological advances and/or changes in regulatory operating requirements, or increases in the current estimates of removal costs when the associated plant will be retired.

The ratemaking treatment of reserve differences varies from one regulatory commission to another, especially in cases where the differences are significant. Usually, the difference is recovered or credited through the use of "remaining life" depreciation rates, in which the total unrecovered investment and net salvage is depreciated over its estimated remaining life. Occasionally, accumulated depreciation is adjusted upward to eliminate the deficiency, and the rate base is reduced for the entire accumulated reserve. When the accumulated reserve is adjusted, the debit side of the adjustment is either amortized to cost of service or eliminated against retained earnings. Amortization to cost of service is generally allowed where the utility can demonstrate that it was not negligent in failing to adjust depreciation rates at an earlier time, since the circumstances leading to the deficiency were largely unforeseen. In rare cases, commissions have not required rate base reduction for differences and still allowed amortization of the debit adjustment to cost of

ATTACHMENT F

STATE	ACQUISITION ADJUSTMENT
Alabama	<p>The Commission regulates the rates of eight small water companies. There is no specific statutory authority dealing with water company acquisition adjustments. However, in <i>Re Mobile Gas Service Corporation</i>, 2003 WL 23101066 (Ala. P.S.C. Oct. 9, 2003), the Commission relied on prior precedent to find that a positive acquisition adjustment would be allowed in rate base where the following principal criteria are satisfied: (1) the purchase price was the result of arm's length negotiations; (2) the acquisition would produce operational efficiencies; and (3) the acquisition would promote the integration of facilities.</p>
Alaska	<p><i>In the Matter of Alaska Power Co. Application</i>, No. U-01-98, Order No. 1 (R.C.A. Feb. 25, 2002) ("The Commission has interpreted this statute [AS 42.05.441(b)] to permit recovery of an acquisition adjustment if the utility demonstrate that the acquisition will provide clear, tangible benefits to ratepayers in an amount at least equal to the acquisition adjustment. However, the Commission has interpreted this rule narrowly and has refused to permit acquisition adjustments in many cases.").</p>
Arizona	<p><i>In the Matter of the Joint Application of Citizens Utilities Company, et. al</i>, Decision No. 63584 (A.C.C. Apr. 24, 2001) ("Arizona-American is cautioned that the Commission will require Arizona-American to demonstrate that clear quantifiable and substantial net benefits to ratepayers have resulted from the acquisition of Citizens' systems that would not have been realized had the transaction not occurred before the Commission will consider recovery of any acquisition adjustment in a future rate proceeding.").</p>
Arkansas	<p>Ark. Code Ann. § 23-4-111 (2008)(Commission will use net book value unless adjustment warranted after consideration of factors such as the reasonableness of original cost and whether customers will receive known and measurable benefits at least equal to the incremental amount sought to be recovered.).</p>

California	<p>Cal. Pub. Util. Code § 2720 (2008)(Commission will use fair market value to establish the rate base value of a distribution system of a public water system acquired by a water corporation. If fair market value exceeds reproduction cost, difference may be included in rate base if commission determines additional amount is fair and reasonable.).</p> <p><i>Application of Citizens Utilities Co. of California (U-87-W), a California Corp., and California-American Water Company, a California Corp., Decision 01-09-057 (Cal. P.U.C. Sept. 20, 2001) (approving alternative sharing program, compliant with § 2720, whereby realized synergies go first to acquiring company to amortize acquisition premium, and second to customers and company in a 90%/10% split).</i></p>
Colorado	No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. In other sectors, acquisition adjustments are considered on a case-by-case basis.
Connecticut	Conn. Gen. Stat. § 16-262o, § 16-262s (2008) (all reasonable costs of the acquisition of troubled or economically nonviable water systems may be recovered in rates).
Delaware	<i>Re Tidewater Water Supply Co., Inc., 2000 WL 33121630 (Del. P.S.C. Nov. 21, 2000) (Commission has an “established practice of not allowing rate base recognition of premiums over net book value paid by an acquirer of a utility,” barring exceptional circumstances).</i>
District of Columbia	<i>PRIVATE WATER SYSTEMS NOT REGULATED</i>
Florida	Fla. Admin. Code 25-30.0371 (2008) (positive acquisition adjustment not allowed in rate base absent extraordinary circumstances; negative acquisition adjustments recognized under certain circumstances).
Georgia	<i>PRIVATE WATER SYSTEMS NOT REGULATED</i>

Hawaii	<p>The Commission has consistently disallowed the recovery of any acquisition adjustments from customers, but evaluates requests on a case-by-case basis.</p> <p><i>In the Matter of the Application of Citizens Communications Company, Kauai Electric Div. and Kauai Island Utility Co-op</i>, Docket No. 02-0060, Order No. 19658 (Haw. P.U.C. Sept. 17, 2002) (approving stipulation which included the following condition: "Applicants acknowledge the commission's policy to not allow recovery from utility customers of goodwill or acquisition premium amounts arising from utility merger and acquisition transactions. In accordance with this policy, [acquiring company] will not seek rate recovery of any goodwill amortization, acquisition premium costs or goodwill impairment changes . . . in future rate proceedings.").</p>
Idaho	<p><i>Re United Water Idaho Inc.</i>, 187 P.U.R.4th 312 (1998) (approving an acquisition adjustment to the rate base "based on its findings that the acquisition benefits customers as well as its conclusion that the purchase price was fair and reasonable and arrived at through arms-length negotiation.").</p> <p><i>Re Resort Water Co., Inc.</i>, 2005 WL 673648 (Idaho P.U.C. Mar. 15, 2005) ("It has been a consistent policy of the Commission that rate base not include the purchase price of a water system unless it could be reasonably shown that the customers have not previously paid for the water system assets . . . the amount to be included in rate base as an acquisition adjustment must be determined on a case-by-case basis").</p>
Illinois	<p><i>Re Consumers Illinois Water Co.</i>, 2003 WL 21108549 (Ill. C.C. Mar. 18, 2003) (traditional practice of Commission is to require that acquisition adjustment be recorded below the line; however, under unique circumstances, ICC will include it in rate base).</p>

Indiana	<p><i>City of Ft. Wayne v. Util. Center, Inc., d/b/a/ Aquasource</i>, 840 N.E.2d 836 (Ind. Ct. App. 2006) (affirming Commission finding that, based on new owner's efforts to remedy problems at troubled utility and arms-length transaction, a return on the acquisition adjustment should be allowed).</p> <p><i>Re Indiana-American Water Co., Inc.</i> 238 P.U.R. 4th 428 (2004) ("[G]ranting a return on an acquisition adjustment but no return of an acquisition adjustment is consistent with past practice of this Commission." The acquisition was found to have "resulted in cost savings in excess of the cost of capital investment needed to make those savings possible. . .").</p> <p><i>Re Lincoln Util., Inc.</i>, 2006 WL 452338 (Ind. U.R.C. Jan. 25, 2006) (order authorizing water company to earn a return on acquisition adjustment).</p> <p><i>Re Indiana-American Water Co., Inc.</i> 2002 WL 32091039 (Ind. U.R.C. Nov. 6, 2002) ("It is the established policy of this Commission to allow an acquisition adjustment in rates in only two events, namely: 1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service and/or lower rates? 2. Does the acquisition result in correction or salvage of an entity identified by this Commission as a 'troubled' utility?").</p>
Iowa	<p><i>Office of Consumer Advocate v. Iowa Util. Bd.</i>, 454 N.W.2d 883, 113 P.U.R.4th 479 (Iowa 1990) ("According to prior board precedent, the acquisition amount may be included in the rate base if actual benefits to customers are established by the utility.").</p>
Kansas	<p>The State Corporation Commission regulates a few very small water companies. There is no specific authority dealing with water company acquisition adjustments. However, in the gas and electric sectors, the Commission limits recovery of an acquisition premium to an amount that reflects the realistic level of savings that the Commission believes can be achieved by the merged company. <i>See In the Matter of the Application of Kansas City Power & Light Co. for approval of its acquisition of all classes of the capital stock of Kansas Gas and Electric</i>, Docket Nos. 172, 745-U; 174, 155-D (Kan. S.C.C. Nov. 14, 1991).</p>
Kentucky	<p><i>Re Kentucky-American Water Co.</i>, 2005 WL 578209 (Ky. P.S.C. Feb. 28, 2005) ("[T]he net original cost of plant devoted to utility use is the fair value for rate-making purposes, unless the utility can prove, with conclusive evidence, that the overall operations and financial condition of the utility have benefited from acquisitions at prices in excess of net book value. Any utility seeking recovery of an acquisition adjustment must justify its purchase decision based on economic and quality of service criteria.")(internal quotations omitted).</p>

Louisiana	No information available.
Maine	As a general matter, acquisition adjustments are not allowed, but requests will be evaluated on a case-by-case basis. Commission staff was unable to recall any requests for acquisition adjustments by water companies in the past decade <i>Re Terms and Conditions of Edmund J. Quirion, 1995 WL 785875 (Me. P.U.C. Nov. 14, 1995)</i> (“We note that this Commission’s general policy has been to use the original cost minus depreciation as the proper method of determining the value of utility property. However, there may be circumstances under which acquisition cost might be considered.”).
Maryland	As a general matter, if sufficient customer benefits are shown the Commission may allow an acquisition adjustment and amortize it over several years. Commission staff noted requests for acquisition adjustments by water companies are rare. <i>Re Greenridge Utilities, Inc., 1997 WL 998596 (Md. P.S.C. June 4, 1997)</i> (“The decision to allow inclusion of the acquisition adjustment in the Company’s rate base is predicated upon consideration of whether such inclusion provide a benefit to the ratepayers.”).
Massachusetts	<i>Guidelines and Standards for Acquisitions and Mergers, D.P.U. 93-167-A at 6-7, 18-19 (1994)</i> (Companies may use savings that result from mergers and acquisitions to offset acquisition premiums and related transaction costs, based on a balancing of the benefits arising from the merger with the costs associated with the merger). Commission staff noted that a showing of savings must be made at the time of the acquisition, and not be based on generalized statements about potential merger benefits. While the policy has been focused on gas and electric company merger and acquisition activity, the precedents in <i>Guidelines and Standards for Acquisitions and Mergers</i> could potentially be applied to water companies.
Michigan	<i>PRIVATE WATER SYSTEMS NOT REGULATED</i>
Minnesota	<i>PRIVATE WATER SYSTEMS NOT REGULATED</i>
Mississippi	<i>State of Miss. v. Miss. Pub. Serv. Comm’n, 435 So.2d 608 (Miss. 1983)</i> (“...public utilities’ amortization of acquisition adjustment is a proper component of cost of service and should be included as a proper operating expense

	when proven by the utility to be beneficial.”).
Missouri	<p>Mo. Rev. Stat. § 393.146(11) (2008)</p> <p>“If the commission orders the acquisition of a small water or sewer corporation, the commission shall authorize the acquiring capable public utility to utilize the commission’s small company rate case procedure for establishing the rates to be applicable to the system being acquired. Such rates may be designed to recover the costs of operating the acquired system and to recover one hundred percent of the revenues necessary to provide a net after-tax return on the ratemaking rate base value of the small water or sewer corporation’s facilities acquired by the capable public utility, and the ratemaking rate base value of any improvements made to the facilities by the acquiring capable public utility subsequent to the acquisition, at a rate of return equivalent to one hundred basis points above the rate of return authorized for the acquiring capable public utility in its last general rate proceeding.</p> <p><i>Re Alliance Gas Energy Corp., 2008 WL 320768 (Mo. P.S.C. Feb. 5, 2008)</i> (observing that “there are strong precedents against allowing acquisition premiums to be reflected in rates when the assets are purchased at more than book value. For example, the Commission has stated that it will not require a company to write down its rate base when the assets are sold at less than book value.”).</p> <p><i>Re UtiliCorp United Inc., 2004 WL 431561 (Mo. P.S.C. Feb. 26, 2004)</i> (“Missouri has traditionally applied the net original cost standard when considering the ratemaking treatment of acquisition adjustments. That means that the purchasing utility has not been allowed to recover an acquisition premium from its ratepayers. But it also means that ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment.”).</p>

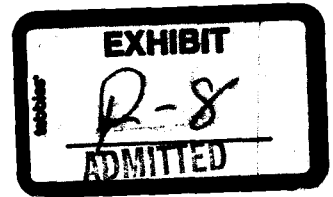
Montana	<p>Mont. Code Ann. § 69-3-109. Ascertaining property values.</p> <p>“The commission may, in its discretion, investigate and ascertain the value of the property of each public utility actually used and useful for the convenience of the public. The commission is not bound to accept or use any particular value in determining rates. However, if any value is used, the value may not exceed the original cost of the property, except that the commission may include all or some of an acquisition adjustment for certain property purchased by a public utility in the purchasing utility’s rate base if the transfer of the property to the purchasing utility is in the public interest.”</p> <p><i>Re North Western Corp., 259 P.U.R.4th 493 (2007)</i> (“It is a long held regulatory principle of this Commission that the value of plant in rate base is determined by original cost less depreciation. Original cost of utility property is determined when the asset is first dedicated to public service. The action of selling a utility, absent any compelling reason, is not sufficient to allow an adjustment in rate base to reflect acquisition costs.”).</p>
Nebraska	<p>No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. In other areas, the Commission sometimes allows acquisition adjustments.</p>
Nevada	<p>The Commission includes the original cost of the acquired system in rate base and does not recognize acquisition adjustments.</p>
New Hampshire	<p><i>Re Lakes Region Water Co., Inc., 2004 WL 3457746 (N.H. P.U.C. Sept. 23, 2004)</i> (after noting commission’s longstanding practice of not allowing recovery in excess of original cost, PUC ordered water company to book purchase price in excess of net book value as an acquisition adjustment so that it was not reflected in future customer rates).</p>
New Jersey	<p>No general policy has been established for dealing with water company acquisition adjustments but the Commission rarely grants acquisition adjustments and will require that a benefit to existing customers be shown by the requesting utility.</p> <p><i>Re Consumers New Jersey Water Company, 1995 WL 592835 (N.J.B.P.U. Sept. 20, 1995)</i>(adopting stipulation where given the “special and unique” circumstance of proven benefits of the acquisition to customers, company would be allowed an acquisition adjustment in next rate base by amortizing adjustment over a period of years and including the unamortized portion into rate base).</p>

New Mexico	<p><i>In the Matter of the Petition By New Mexico-American Water Company, Inc. to Change Its Service Rates, Case No. 2202 (N.M. P.S.C. Dec. 28, 1988)</i> (order approving stipulation that excluded the acquisition adjustment from the rate base and its amortization from the cost of service - acquired assets would be treated as if transferred at original cost.).</p> <p>Commission staff noted that general policy is to not allow an acquisition adjustment unless net benefit to customers is proven.</p>
New York	<p><i>Proceeding on Motion of the Commission to Establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities, Case No. 93-W-0962 (N.Y. P.S.C. Aug. 8, 1994)</i> (established guidelines for acquisition of small water companies whereby, if certain customer benefits are shown, Commission may provide incentives such as inclusion of acquisition adjustment in rate base (if purchase price greater than acquired company rate base) or inclusion of acquired company rate base (if purchased for less than rate base)).</p> <p><i>Joint Petition of United Waterworks Inc. and South County Services Co., Inc. for Permission for United Waterworks to Acquire the Stock of South County Water Corp., Case No. 02-W-0949 (N.Y. P.S.C. May 21, 2004)</i> (citing to policy on acquisition of small water utilities, allowed acquiring company to include book value of stocks in rates instead of lower purchase price).</p> <p><i>Joint Petition of Aqua New York, Inc., f/k/a Kingsvale Water Co., Inc., and New York Water Service Corp., Case No. 06-W-0700 (N.Y. P.S.C. Dec. 20, 2006)</i> (the full amount of purchase premium treated as goodwill (not recoverable in rates) where acquisition was not of a small water utility).</p>
North Carolina	<p><i>In the Matter of Petition of Utilities, Inc., 147 N.C. App. 182, 555 S.E.2d 333 (2001)</i> (affirming Commission approach whereby it would refrain from allowing rate base treatment of an acquisition adjustment unless the purchasing utility established by the greater weight of the evidence that the purchase price was prudent and that both the existing customers of the acquiring utility and the customers of the acquired utility would be better off (or at least no worse off) with the proposed transfer, taking into consideration rate base treatment of any acquisition adjustment).</p>
North Dakota	<p>PRIVATE WATER SYSTEMS NOT REGULATED</p>
Ohio	<p>The Commission includes the original cost of the acquired system in rate base and does not allow acquisition adjustments. <i>Re Dayton Power and Light Co., 21 P.U.R.4th 376 (Oh. P.U.C. 1977)</i> (proposed acquisition adjustment should "clearly" be excluded from rate base given state's use of original cost.).</p>

Oklahoma	Acquisition adjustments are not allowed in rate base absent extraordinary circumstances, although requests are evaluated on a case-by-case basis. Commission staff did not recall any recent requests for acquisition adjustments by water companies.
Oregon	Or. Admin. R. 860-036-0716 (2008) (water utility may petition Commission for approval of acquisition adjustment in rates where benefits of acquisition outweigh the increase to customers' rates resulting from acquisition).
Pennsylvania	66 Pa. C.S.A. § 1327 (2008) (positive acquisition adjustments allowed under identified circumstances where small, troubled or non-viable water systems are acquired and improved; negative acquisition adjustments must be amortized to utility operating income unless, in the Commission's discretion, the public interest would not be served by doing so).
Rhode Island	Acquisition adjustments are generally not allowed, although they are evaluated on a case-by-case basis. Cost savings or other extraordinary circumstances may justify an acquisition adjustment. Commission staff did not recall any requests for acquisition adjustments by water companies in the past decade. <i>In re: Petition of Valley Gas Co., Bristol and Warren Gas Co. and Southern Union Company for Approval of Mergers</i> , Docket Nos. D-00-02, D-00-03 (R.I. P.U.C. July 24, 2000) (order approving a settlement agreement which contained the following term: "The Settling Parties agree that the Companies will not seek direct or indirect recovery of any acquisition premium in rates either through an amortization or rate base adjustment in future rate cases . . .").
South Carolina	<i>Re Georgia Water & Well Serv., Inc.</i> , 233 P.U.R.4th 482 (2004) ("If a regulatory agency determines that the cost was reasonable and beneficial to the customers, an above-the-line expense could be allowed as an Amortization of Utility Acquisition Adjustments." However, "[t]he prevailing rule relating to the acquisition of utility plant previously used in a regulated business is that the plant must continue to be recorded at the depreciated original cost to the first owner devoting the property to public service.").
South Dakota	PRIVATE WATER SYSTEMS NOT REGULATED
Tennessee	The Authority does not have a general policy on acquisition adjustments. Generally speaking, the purchase of utility plant previously used in providing utility service is recorded on the acquiring company's books at original cost, net of accumulated depreciation. Exceptions would be considered only if the price above the seller's original cost was clear in the public interest and would be addressed on a case-by-case basis.

Texas	30 Tex. Admin Code § 291.31(d) (2008) (positive acquisition adjustment allowed under identified circumstances).
Utah	Commission Staff stated that, in general, when the acquired asset is already a utility asset, the book value goes into rat base. When the acquired asset was not previously a utility asset, the purchase price goes in to the rate base. <i>Re Utah Power and Light Co.</i> , 53 P.U.R.4th 461 (Ut. P.S.C. May 23, 1983) (“The commission agrees that in the context of acquiring assets already dedicated to the providing of public service the general rule for determining the value of such acquired property for rate-making purposes is depreciated book value . . . The commission also recognizes, however, that there may be exceptions to this general rule should sufficient benefits accrue to the acquiring public utility and its ratepayers to justify deviations from net book value treatment. It should be emphasized that this exception would be an unusual circumstance and would be evaluated on a case-by-case basis.”).
Vermont	Board includes acquisition adjustments below the line; never included in rates. Board staff was unable to recall any recent requests for acquisition adjustments by water companies. <i>Joint Petition of Young’s Cable TV Corp. and Okemo Vue, Inc.</i> , 1986 WL 361091 (Vt. P.S.B. May 26, 1986) (“the Board policy on rate-base acquisition adjustments is that permitted earnings on rate-base investment are limited to the depreciated cost of utility property when first placed into service, and that an upward rate base adjustment will not be permitted when ownership of the assets is directly or indirectly at a price in excess of their depreciated original cost.”)
Virginia	<i>Re Virginia Natural Gas, Inc.</i> , 250 P.U.R.4th 421 (2006) (“An acquisition adjustment is allowed only in extraordinary circumstances and may be authorized if the applicant utility satisfies certain criteria . . . (i) the purchase price was determined in an arms-length bargaining and (ii) the purchase was an investment made prudently for the benefit of the customers and the utility.”).
Washington	<i>Washington Util. and Transp. Comm’n v. PacifiCorp</i> , 2006 WL 1517095 (Wash U.T.C. Apr. 17, 2006) (“When a utility purchases a plant, it may seek an acquisition premium adjustment to reflect that the price paid for the plant may be higher than its book value. However, the cost of the premium is not included in rate base unless the Commission allows such treatment after finding the underlying plant purchase was prudent.”). <i>In the Matter of the Application of Herman Suess Applicant, For the Sale and Transfer of Assets to Pattison Water Co.</i> , 2005 WL 2660173 (Wash. U.T.C. June 15, 2005) (Staff advised applicant that “absent a showing of commensurate benefits, acquisition adjustments are not included in rate base for inclusion in rates.”).

West Virginia	<p>No general policy has been established for dealing with water company acquisition adjustments. Acquisition adjustments are often not allowed.</p> <p><i>Re West Virginia-American Water Co.</i>, 231 P.U.R.4th 423 (W. Va. P.S.C. Jan. 2, 2004) (ordered negative acquisition adjustment to rate base).</p> <p><i>West Virginia-American Water Co. and East Bank Water Dep't</i>, Case No. 00-1719-W-PC (W. Va. P.S.C. Feb. 6, 2001) (ordered acquiring company to record the book cost of assets, and "[a]ny amount paid in excess of the net book value of the acquired assets, as adjusted, should be recorded in [the acquisition adjustment account] and be amortized over 20 years. Any amount of asset book value in excess of the amount paid will be considered as a contribution. Lastly, any necessary rate recognition relating to this acquisition will be given the appropriate treatment in the [next rate case].").</p>
Wisconsin	<p><i>Joint Application for Approvals Related to Wisconsin Power and Light Company's Sale of its Beloit Area Water Utility Assets to the City of Beloit</i>, 2003 WL 22220326 (Wis. P.U.C. Sept. 19, 2003)(after finding sufficient benefits to customers, allowed city to recover in customer rates a straight-line amortization of acquisition adjustment over 25 years and a return on the unamortized balance).</p> <p><i>Preliminary Agreement of the Village of Footville, Rock County, as an Electric Public Utility, to Sell Its Electric Public Utility Plant to Wisconsin Power and Light Company</i>, Dockets 2040-EA-100, 6680-EB-103 (Wis. P.U.C. Feb. 24, 1989)(As a general matter, a utility must provide some substantial physical or electrical benefit to the purchaser's system in order to be exempted from the ordinary rule that utility customers pay no more than net book value. Redistribution of costs or spreading costs over more customers is not a system benefit in and of itself.).</p>
Wyoming	<p>No general policy has been established for dealing with water company acquisition adjustments. Commission staff was unable to recall any requests for acquisition adjustments by water companies. Requests would be reviewed on a case-by-case basis.</p>



WILLOW VALLEY WATER CO., INC.

EPCOR WATER ARIZONA, INC.

DOCKET NOS. W-01732A-15-0131 and W-01303A-15-0131

SURREBUTTAL TESTIMONY

OF

JEFFREY M. MICHLIK

ON BEHALF OF THE

RESIDENTIAL UTILITY CONSUMER OFFICE

NOVEMBER 13, 2015

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EXECUTIVE SUMMARY - SURREBUTTAL

The Residential Utility Consumer Office ("RUCO") has reviewed the rebuttal testimony of EPCOR Water Arizona Inc. ("EWAZ") , and Global Water Resources Inc. ("Global"). I will address the Companies rebuttal issues relating to the acquisition premium.

RUCO continues to recommend that the Commission deny EWAZ's acquisition premium.

Mr. Ralph Smith will address issues related to IRS normalization rules, and offers the three alternatives to the Commission:

(1) accept the requirement to establish the Regulatory Liability or alternative ratepayer protections as one of the conditions that are being required to obtain approval of the change-of-control transaction, or (2) withdraw the proposed transaction and re-submit it with a structure that does not involve extinguishment of existing utility ADIT, or (3) have the proposed transaction rejected since a significant source of ratepayer harm (increased rate base cause by the transaction and how it is structured) has not been remedied sufficiently for the transaction to be in the public interest.

I. INTRODUCTION

Q. Please state your name for the record.

A. My name is Jeffrey M. Michlik.

Q. Have you previously filed testimony regarding this docket?

A. Yes, I have. I filed direct testimony in this docket on January 23, 2015.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony will address the Companies rebuttal positions, both Global Water ("Global") and EPCOR Water Arizona, Inc's ("EWAZ") proposals and comments pertaining to the acquisition premium. In addition, the testimony of Mr. Ralph Smith will address what has been done in other jurisdictions and what should be done in this case to make the ratepayer whole.

Q. How is your surrebuttal testimony organized?

A. My surrebuttal testimony is presented in two sections. Section I provides an introduction and Section II addresses rebuttal testimony from the Companies witnesses.

Q. Are there any corrections you would like to make at this time?

A. Yes. Previously in direct testimony, I stated Global was a Arizona "C" Corporation. This is incorrect Global is a "Public Utility Holding Company" as defined in A.A.C. R14-2-801.4.

1 **II. REBUTTAL POSTIONS OF GLOBAL AND EWAZ**

2 **The accumulated deferred income tax ("ADIT") balance that benefits**
3 **ratepayers goes away under the Companies' proposal is bad public policy,**
4 **unfair to the ratepayer and not in the public interest**

5 **Q. Have the Companies, both Global and EWAZ in this case rejected both**
6 **Staff's and RUCO attempts to make ratepayers whole in this**
7 **transaction through a regulatory liability account to account for the**
8 **loss of ADIT benefit to ratepayers?**

9 **A. Yes.**

10

11 Ron Fleming on page 16, line 8 of his rebuttal testimony states "Staff's and
12 RUCO's proposed "regulatory liability" for ADIT should be formally rejected.
13 It creates a strong disincentive for future consolidation."

14

15 Paul Walker on page 5, line 5 states "Basically, if this proposal is adopted,
16 the Commission will be sending a strong message for both potential buyers
17 of water utilities (including troubled water utilities), and sellers of water
18 utilities, and that message will be "**don't buy any utilities**" or "don't sell
19 your water utility". That is not the message the Commission should send."

20

21 Sarah Mahler on page 10, line 18 states "Staff is imputing the value of ADIT
22 and reclassifying the ADIT balance as a regulatory liability. If approved this
23 action sets in place a policy which will have a negative impact on the
24 consolidation of small water systems in the State of Arizona, because it may
25 make it more difficult to reach a satisfactory purchase price."

1 **Q. Does the intentional disregard of ratepayers' interest from the**
2 **Companies surprise you?**

3 A. No, not really, the bottom line is the way the accounting transaction is
4 structured; ratepayers will lose the benefit of \$260,224. If the
5 Commissioners' decision is to make ratepayers whole, from the Companies'
6 perspective it's clear that it is bad public policy. Furthermore, during the
7 course of rate cases, one sided adjusters seem to be the norm that only
8 work to the favor of companies and to the detriment of ratepayers, which
9 from the Companies perspective seems to always be good public policy.

10
11 **Q. Please respond to Mr. Walkers comment on page 3, line 26. "In my**
12 **experience, "pretending" and "accounting" are not things that go well**
13 **together. Ratemaking should reflect economic realities, and the reality**
14 **is that these taxes will no longer be deferred."**

15 A. RUCO finds this comment amusing, in light of Mr. Walkers support of
16 Commission's policy regarding income taxes for pass-through entities. (see
17 Attachment A). It's hard to believe this is an oversight on Mr. Walker's part
18 – rather RUCO believes that what Mr. Walker really means is that
19 "pretending" and "accounting" are not things that go well together when they
20 benefit the ratepayer.

21
22 **Q. Has the Commission adhered to or followed the IRS code and GAAP**
23 **(which is covered in Accounting Standards Codification ("ASC") 740**
24 **Income Taxes) in the past?**
25

1 A. No. In fact, in the case of Limited Liability Corporations ("LLC's") and
2 Subchapter S Corporations ("Sub S") the Commission has created its own
3 tax methodology for ratemaking purposes, which Mr. Walker agrees with
4 since it works to the benefit of the Company and to the detriment of
5 ratepayers.

6
7 **Q. Please elaborate?**

8 A. Under the Commission's Income Tax Policy (see Attachment B, followed by
9 RUCO's comments) the ratepayers now have to pay the utility owners
10 personal tax liability under pass through corporate organization (Chapter S
11 and Limited Liability Corporation). The Commission's tax policy provides for
12 what a federal court and others have called a "phantom tax". It is a
13 phantom tax or pretend tax because these utilities do not pay income tax –
14 period. Thus, the Commission can, and has, created its own tax policy and
15 is not bound by GAAP.

16
17 Furthermore, and equally egregious, the Commission's policy does not
18 require the shareholders to submit their actual income tax statements
19 guaranteeing that the amount that is imputed is not the actual tax paid by
20 the shareholders – the only thing that is not "pretend" when it comes to the
21 Commission's income tax policy is the unfortunate fact that the Commission
22 has this policy. In the *real* world of public accounting, if you do not supply
23 information to the auditor to verify, it would be a scope violation, which
24 would result in a qualified opinion by the auditor.

25

1 **Q. Why are we even talking about ADIT, as most small water companies**
2 **in Arizona are independently owned and operated (D&E size**
3 **companies) that don't have ADIT balances?**

4 A. Most small water utility companies that I have worked on in the past do not
5 have ADIT balances. However, occasionally you will find small water utilities
6 organized as an Arizona C corporation, as in this case.

7
8 **Q. Why is that?**

9 A. Most small water utilities in Arizona, are usually very small (mom and pop)
10 operations. They are in the land or home development business, and
11 operating a water system is more of a side thought. Large companies that
12 do business in Arizona, such as Global, EPCOR, Liberty Utilities, and
13 Arizona Water Company are in the business of providing water services to
14 customers in multiple systems or districts across Arizona, and as a result
15 have ADIT balances.

16
17 **Willow Valley is already consolidated to the extent Global's management**
18 **team provides resources and capital to the system**

19 **Q. Has Willow Valley Water system already been consolidated?**

20 A. Yes. In 2006 when Global purchased the West Maricopa Combine, as
21 explained in Mr. Fleming's rebuttal testimony on page 6, line 16, and Willow
22 Valley was one of the systems acquired in that purchase. Therefore, the
23 Company, after that point, was receiving shared services from Global.

1 **Q. Please, respond to Mr. Walkers comment on page 10, line 3 of his**
2 **rebuttal testimony "I am shocked that Mr. Michlik referred to the**
3 **proposed policy favorably. Frankly, the 1999 Water Task Force was a**
4 **disaster as a policy initiative."**

5 **A.** First, I do not recall referring to the policy favorably. I was just stating the
6 facts. Second, I assume Mr. Walker, must be equally as shocked that
7 Chairman Susan Bitter Smith, cited the 1999 Water Task Force in her 2014
8 power point presentation "Acquisitions and Consolidations in Arizona's
9 Water and Wastewater Industry" (see Attachment C for a copy of this
10 presentation)."

11
12 Further, the goals as outlined in Chairman Bitter Smith's presentation
13 highlighted the following goals from the 1999 Water Task Force:

- 14
- 15 • Reduce the number of small, non-viable water systems through new rules
16 and procedures.
 - 17 • Many of Arizona's water companies are quite small; the majority of them
18 have less than \$250,000 in annual revenues... Because of their small base
19 of customers, even quality managers of small companies may find it difficult
20 to raise sufficient revenues to make needed capital investments.

21
22 RUCO agrees with these points. However, this is not the case here. Willow
23 Valley is not a non-viable water system nor does it find itself having difficulty
24 raising capital investments.

Commission Decisions and Policy dictate clear, quantifiable and substantial benefits realized by ratepayers that are unlikely to be realized if the transaction occurs as proposed

Q. Mr. Walker's comments on page 12, line 1, of his rebuttal testimony suggests that a benefit as a result of this transaction is "boots on the ground?"

A. Yes, but he fails to quantify the additional costs associated with this benefit. With the absence of a meaningful cost benefit analysis on the additional costs associated with the *boots on the ground*, his benefit is just conjecture.

Q. And hasn't that been the standard used in the past by the Commission?

A. Yes. In Decision No. 63584 (dated April 24, 2001)¹, the Commission on page 11 line 22, stated the following:
"Arizona-American is cautioned that the Commission will require Arizona-American *to demonstrate that clear, quantifiable and substantial net benefits to ratepayers have resulted from the acquisition* of Citizens' systems that would not have been realized had the transaction not occurred before the Commission will consider recovery of any acquisition adjustment in a future rate proceeding."

¹ Docket No. W-01032A-00-0192 ET AL. Involving Arizona-American's purchase of assets from Citizens.

1 Q. In fact, was EWAZ given the opportunity to demonstrate that clear,
2 quantifiable and substantial net benefits to ratepayers would result in
3 this case?

4 A. Yes. In Staff data request 1.8.

5

6 EWAZ responded "The benefits are by their nature not quantifiable, and
7 therefore no schedules quantifying the benefits are provided."

8

9 ADIT balances have been considered before regarding the purchase of
10 assets and dealt with in an equitable way for ratepayers

11 Q. Please respond to Mr. Walker's comment on page 4, line 22, "What
12 Staff and RUCO are proposing is unprecedented – they are proposing
13 to take a tax-related liability from one company and assign it to
14 another company as a condition of acquisition. Do you agree with this
15 statement?"

16 A. No. In Decision No. 63584, which was a purchase of assets, on page 11,
17 line 3 the Decision stated the following:

18 "RUCO also expressed concern regarding the impact of the transaction on
19 Citizens' accumulated deferred income taxes ("ADITS"), which totaled
20 approximately \$5.2 million as of December 31, 1999, and Citizens'
21 investment tax credits ("ITCs"), which totaled approximately 52.2 million as
22 of the same date. Under the Agreement, any decision on the treatment of
23 ADITs and ITCs will be deferred until Arizona-American seeks new rates in
24 a future proceeding."

25

1 **Q. Was the same standard cited in Decision No. 67093 (dated June 30,**
2 **2004)²?**

3 A. Yes, on page 6, line 19, the standard was reaffirmed.
4

5 **Q. What about the ADIT issue, was it also cited in this Decision?**

6 A. Yes, on line page 7, line 1 the following was stated:

7 "In this proceeding, the Company has not attempted to prove the net
8 benefits as required by Decision No. 63584; is not requesting recovery of
9 its recorded acquisition adjustment; and states that it has not included an
10 acquisition adjustment in its RCND rate base computation (Exh. A-74 at 10-
11 11). Staff testified that if in the future Arizona-American requests recognition
12 of an acquisition adjustment, the effect of lost accumulated deferred income
13 credits of \$4.6 million and investment tax credits of \$1.9 million must be
14 accounted for in the calculation of "net benefits" as required by Decision No.
15 63584, because the effect of the elimination if these items in the transfer of
16 assets from Arizona-American to Citizens was an increase to rate base
17 (Exh. S-47 at 20-21)."

18
19 The Commission stated in this case it was premature to consider this issue
20 until an acquisition premium is recognized. However, the facts are
21 unchanged at least from Staff's view that the ADIT and ITC credits must be
22 accounted for in the calculation of "net benefits" as required by Decision No.
23 63584.
24

² Docket No. WS-01303A-02-0867 ET AL. Involving Arizona-American's general rate case.

1 It's clear the Commission recognized that the two issues are intertwined just
2 as they are now.

3
4 Including ratepayers interest in a Commission decision is not
5 unprecedented. But for the sake of argument, would the fact that there is no
6 precedent be justification for a position that is so clearly inequitable to the
7 ratepayer in this case? The standard is the "public interest" and precedent
8 while a factor is far from the overriding concern where such inequities exist
9 – besides, as just explained the precedent works against Mr. Walker's
10 position.

11
12 **Q. On page 5, line 26, of Mr. Walker's rebuttal testimony he starts a**
13 **discussion about ADIT and possible Internal Revenue Service ("IRS")**
14 **Code violations. Please comment.**

15 **A. Mr. Ralph Smith will address issues related to IRS normalization rules, and**
16 **offers the three alternatives to the Commission:**

17 (1) accept the requirement to establish the Regulatory Liability or alternative
18 ratepayer protections as one of the conditions that are being required to
19 obtain approval of the change-of-control transaction, or (2) withdraw the
20 proposed transaction and re-submit it with a structure that does not involve
21 extinguishment of existing utility ADIT, or (3) have the proposed transaction
22 rejected since a significant source of ratepayer harm (increased rate base
23 cause by the transaction and how it is structured) has not been remedied
24 sufficiently for the transaction to be in the public interest. I would note
25 however, that Mr. Walker supports his conclusion with a document from the

1 Public Service Commission of the State of Nebraska with no docket number
2 or Decision No. associated with it (see Attachment-Walker-1).

3
4 **Q. RUCO has received data requests from Global on whether the**
5 **Commission policies RUCO cited in its direct testimony were acted**
6 **on, how do you respond (see Attachment D)?**

7 **A.** It is really a question of which came first, the chicken or the egg. Obviously
8 the same wording appears in Staff's report (dated March 19, 2012), already
9 included in Attachment C of my direct testimony reproduced again below:

10
11 "Staff concludes that the granting of acquisition premiums should be
12 withheld at the time the proposed sale/transfer is being considered and that
13 authority should be granted to allow potential recovery upon the acquiring
14 utility meeting specified conditions such as **1) *demonstrating clear,***
15 ***quantifiable and substantial benefits realized by ratepayers that are***
16 ***unlikely to have been realized had the transaction not occurred;*** 2)
17 balancing the value of the realized benefits against the rate impact; and 3)
18 granting any recovery of an acquisition premium over an extended time and
19 requiring continued recovery to be re-justified in subsequent rate
20 proceedings to encourage continuous delivery of improved, quality service."

21
22 **Q. So the language that was included in the 2009 Staff reported was**
23 **already acted upon by the Commission in Decision No. 63584?**

24 **A.** Yes.
25

1 **Q. In addition, please comment on page 3 line 8 of EWAZ's witness Sarah**
2 **Mahler's testimony that "RUCO references a memorandum from the**
3 **Utilities Division dated June 29, 2001, which was not adopted by the**
4 **Commission, which details a proposed policy for Class D and E water**
5 **system acquisitions."**

6 **A. This is incorrect, I have included a copy of Decision No. 62993 (see**
7 Attachment E) the Commission approved - Staff's six conditions as they
8 relate to acquisition adjustments. The policy elaborated on how to
9 implement the six general conditions, which were approved by the
10 Commission Decision.

11
12 Further the Decision also states the acquisition incentive may be granted in
13 one of two ways: (1) recovery of an amount paid in excess of the book value
14 of the acquired company's assets (acquisition adjustment), or (2) a rate of
15 return premium, but not both. ***What EWAZ is proposing has not been***
16 ***acted on or adopted by the Commission.***

17
18 Further, many of the policies discussed in Decision No. 62993, many of
19 which were developed by the Water Task force and then went on to become
20 Commission Policy - for example, tiered rates. In fact, Global has utilized
21 tiered rates in its rate design, and in some instances have five tiered rates
22 coupled with incentives. Therefore, I disagree with Mr. Walker's statement
23 that the Water Task force was a waste of time and Ms. Mahler's statement
24 that the Commission has not adopted this.

25

Companies' proposals have nothing to do with the Commission's policy of trying to consolidate small independently operated non-viable water systems

Q. Does this transaction have anything to do with addressing the Commission's policy of trying to consolidate small independently operated non-viable water systems, in which there could be benefits realized through consolidation?

A. No. What the Commission will be deciding is whether large size companies in Arizona can flip some of their consolidated systems between themselves, and ask ratepayers to pay for a name change to the detriment of ratepayers. If this current case is successful it will encourage more large size water utility companies in Arizona to flip their systems between one another. As Mr. Sabo sated in his November 5, 2015 pleading - "This case concerns the transfer of the Willow Valley service area from one well-qualified company to another well-qualified company."

Q. Mr. Walker on page 10, line 17, claims you are biased, how do you respond?

A. Even though RUCO, still does not support the white paper, I have provided a copy of the whole white paper (see Attachment F). I am no more biased about ratepayers that RUCO represents than he is about his clients position.

Q. Please comment on Mr. Walker's statement that RUCO backed out of the white paper, on page 10, line 13 of his rebuttal testimony.

1 A. Yes, that is correct, for the reasons that are really not relevant here since
2 this case has nothing to do with the Commissions policy of the consolidation
3 of small independently non-viable water companies.
4

5 **No traditional Net Present Value ("NPV") calculation was completed to justify**
6 **the transaction**

7 Q. You stated on page 10 of your direct testimony that you were waiting
8 on a response from the Company on whether they had conducted a
9 NPV analysis or not, have you received additional information?

10 A. Yes, in RUCO 5.01 (see attachment G), the Company stated:
11 "The agreed purchase price was the result of arms-length negotiations and
12 not a result of a financial model. Moreover, EWAZ's NPV analysis has no
13 relevance on whether or not the proposed acquisition is in the public interest
14 as EWAZ has committed to abide by the rates established by the
15 Commission in Willow Valley's most recent rate case. EWAZ further objects
16 to DR RUCO 5.01(a) to the extent that the information requested is highly
17 confidential business information or trade secrets. Disclosure of the
18 information requested by RUCO, even pursuant to a protective agreement,
19 would adversely impact EWAZ's future operations and the Commission's
20 stated policy of encouraging the consolidation of private utilities."
21

22 Based on the answer, it's more likely than not that a NPV analysis was not
23 prepared, or at least the way it is traditionally completed to support an
24 acquisition. No traditional NPV was prepared to justify the transaction that
25 RUCO has seen or that was submitted as part of the application.

1 RUCO further disagrees with the Company that an NPV analysis is not in the
2 public interest.

3
4 Recognizing an ADIT balance between one well-qualified company to
5 another well-qualified company will encourage the buyer to negotiate a
6 better deal for ratepayers

7 Q. If the selling Company knows that the Commission will recognize
8 ratepayer benefits in a sale of assets transaction, will this put the
9 prospective buyer in a better position?

10 A. Yes. If ratepayer benefits are considered in the sales transaction this will
11 lower the purchase price, and provide the purchaser/buyer with an incentive
12 to consolidate non-viable water systems. Furthermore, acquisition
13 premiums, if not crafted correctly such as the case here, will provide a
14 further lack of incentive by the seller and buyer to negotiate the best deal
15 for ratepayers.

16
17 Prudency issues

18 Q. Has RUCO already addressed its prudency issues in its direct
19 testimony?

20 A. Yes.

21
22 Q. Do you have anything else to add?

23 A. Yes.

24
25 Q. Has the Commission addressed the prudency issue with EWAZ before
26 in a recent filing?

1 A. Yes. In Decision No. 74174 (dated October 25, 2013)³, the Commission on
2 page 4 line 17, stated the following:

3

4 "Staff is recommending approval of the joint Application for the transfer of
5 NMVC's assets and Certificate to EPCOR, but is recommending the denial
6 of the request that NMVC's rate base as of December 31, 2012, be
7 determined to be \$2,137,020, and that any determination for the recovery
8 of an additional 10 percent of rate base payment or any other payment is
9 premature and is better determined in the context of a general rate case."

10 "We agree with Staff that it would be inappropriate to make a rate base
11 determination in this proceeding."

12

13 Q. Is this EWAZ's attempt to get around the prudence issue surrounding
14 the rate base determination, by claiming that the Company is not
15 requesting that the acquisition premium be included in rate base (see
16 testimony of Company witness Sarah Mahler, page 6 line 8)?

17 A. That is debatable. What is not, is that this is the first time RUCO is aware of
18 an acquisition adjustment not being included in rate base. The fact remains
19 the same, the Company is asking for a predetermination by the Commission
20 to build plant outside a rate case, and recover it through a surcharge before
21 the issue can be vetted in a rate case.

22

³ Docket Nos. W-02259A-13-0138 and W-01303A-13-0138. Involving the sale of assets and transfer of a Certificate of Convenience and Necessity to EPCOR from North Mohave Valley Corporation.

1 Again as mentioned in my Direct Testimony, this creates a dangerous
2 precedent of the Commission making prudency determinations outside of a
3 rate case.

4
5 **Q. Please recap your surrebuttal findings:**

6 **A.** RUCO's findings are as follows:

- 7 a. The ADIT balance that benefits ratepayers goes away under the
8 Companies' proposal is bad public policy, unfair to the ratepayer and
9 not in the public interest.
- 10 b. Willow Valley is already consolidated to the extent Global's
11 management team provides resources and capital to the system
- 12 c. Commission Decisions and Policy dictate clear, quantifiable and
13 substantial benefits realized by ratepayers that are unlikely to be
14 realized if the transaction occurs as proposed
- 15 d. ADIT balances have been considered by the Commission before
16 regarding the purchase of assets and dealt with in an equitable way
17 for ratepayers
- 18 e. Companies' proposals have nothing to do with the Commissions
19 policy of trying to consolidate small independently operated non-
20 viable water systems
- 21 f. No traditional Net Present Value ("NPV") calculation was completed
22 to justify the transaction.
- 23 g. Recognizing an ADIT balance between one well-qualified company to
24 another well-qualified company will encourage the buyer to negotiate
25 a better deal for ratepayers
- 26 h. Prudency Issues

1 **Q. Based on these findings what is RUCO's recommendation?**

2 A. RUCO continues to recommend that the Commission deny EWAZ's
3 acquisition premium.

4

5 **Q. Does your silence on any of the issues, matters or findings addressed**
6 **in the testimony of any of the witnesses for the Company constitute**
7 **your acceptance of their positions on such issues, matters or**
8 **findings?**

9 A. No. RUCO limited its discussion to the specific issues outlined above.
10 RUCO's lack of response to any issue in this proceeding should not be
11 construed as agreement with the Company's position in its rebuttal
12 testimony; rather, where there is no response, RUCO relies on its original
13 direct testimony.

14

15 **Q. Does this conclude your rebuttal testimony?**

16 A. Yes.

17

ATTACHMENT A

APS isn't 1st utility to delve into elections

Ryan Randazzo, The Republic | azcentral.com 11:13 a.m. MST June 30, 2014



(Photo: azcentral)

Candidates running for the Arizona Corporation Commission have been debating whether it is appropriate for Arizona Public Service Co., a company regulated by the commission, to get involved in the elections.

They argue that although legal, it is inappropriate for a utility to spend money and help select those who will set the company's prices for power.

The debate so far has overlooked the fact that small water utilities helped elect three of the sitting regulators.

In 2012, a water-company lobbyist named Paul Walker contributed money to the benefit of three Republicans who were elected to the Arizona Corporation Commission.

Walker chaired a group called "Arizonans for Responsible Water Policy" that spent \$9,000 during the 2012 election cycle on telemarketing campaigns to benefit Bob Stump, Susan Bitter Smith and Bob Burns, according to filings with the Arizona secretary of state.

[: Candidates for Corporation Commission differ on corporate support \(/story/money/business/2014/06/30/candidates-for-corporation-commission-differ-on-corporate-support/11781315/\)](#)

[: APS can't promise to keep out of politics \(/story/money/business/2014/06/24/aps-promise-keep-politics/11321909/\)](#)

[: Candidates suspect APS influencing Corp. Comm. race \(/story/money/business/2014/06/19/candidates-suspect-aps-influencing-corp-comm-race/10886483/\)](#)

Since then, his group has successfully fought for rate hikes that will have utility customers paying the income taxes of some water companies' owners, and also paying nearly automatic rate increases without the companies having to endure a lengthy rate hearing.

Walker represents Arizona Water Co., Liberty Water and Global Water. It has previously counted Pivotal Utilities as a member, he said.

Walker said utilities contributing to the political campaigns of those that will set rates for them should not be controversial so long as the motives are pure.

"I think the question is why — why are (utilities) supporting certain candidates in the race," he said.

"I think we need to make a decision what is best for Arizona. We are not out electing people who will provide us abnormal returns," Walker said.

He said his clients wanted to help defeat Democrats Paul Newman and Sandra Kennedy because as commissioners, they made "reckless" decisions that were bad for the companies and bad for the state.

One of those decisions was opposing a water utility that wanted to spend \$300,000 to recharge an aquifer, which is required by state law, Walker said.

"Those decisions are bad for Arizona," he said.

The rate hikes Walker's group has helped pass are controversial.

Last year, the commissioners voted 4-1 to allow the owners of small water companies organized as S corporations to charge their customers for the income-tax expense they incur through the company.

Commissioner Brenda Burns opposed the measure.

About 40 AARP members held a protest at the commission in March during a hearing for Pima Utility Co., which was the first to take advantage of the change.

Pima is primarily owned by developer Ed Robson's family trust, which will shift its tax liability to utility customers.

Pima is not one of Walker's clients, he said, and none of his clients benefits from the income-tax change. But Walker's group pushed for the increase because he said it helps several other small water companies improve their operations.

"While some argue that anything that raises rates is bad for customers, that view does not reflect the reality of the economic and environmental intersection that exists in reality," he said in a letter to then-Commissioner Kennedy in 2012, shortly before his group spent the money to help defeat her and the other Democrats in the election.

Walker's group also pushed for a form of nearly automatic rate hikes that small water companies can enact without going through a lengthy rate hearing at the commission.

That policy is controversial enough that the state consumer advocate, the Residential Utility Consumer Office, has taken the case to the Arizona Court of Appeals regarding how it was implemented.

Walker said his group supports the increases because they allow water companies to gradually increase rates annually, rather than file large rate increases every few years, and he said consumers prefer such gradualism.

"People don't want to see their budget change dramatically every four or five years," he said.

He said RUCO officials understand the perspective and differ with Walker's group only regarding whether the regulators have the authority to allow such gradual increases.

Walker said the water companies he represents have not decided whether they will support any of the candidates for the commission this year.

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ATTACHMENT B



0000142958

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

FEB 22 2013

BOB STUMP - Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

DOCKETED BY

NR

IN THE MATTER OF THE COMMISSION'S
GENERIC EVALUATION OF THE
REGULATORY IMPACTS FROM THE USE
OF NON-TRADITIONAL FINANCING
ARRANGEMENTS BY WATER UTILITIES
AND THEIR AFFILIATES.

Docket No. W-00000C-06-0149

DECISION NO. 73739

Open Meeting
February 12, 2013
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On June 15, 2012, a draft policy statement ("Policy Statement") regarding the treatment of income tax expense for tax-pass through entities was filed in this docket for the Commission's consideration.

2. Comments were filed by various interested parties. The Commission's Utilities Division Staff ("Staff") docketed a Staff Report on June 27, 2012 providing Staff's analysis and recommendations for Commission consideration.

3. A revised draft policy statement ("Revised Policy Statement") was docketed on February 11, 2013 and is attached as Attachment 1.

4. During the Commission Open Meeting held on February 12, 2013, the Commission considered the Revised Policy Statement, the Staff Report, and the filed and oral comments provided by interested parties. After deliberation, the Commission voted to adopt the Revised Policy Statement.

...

CONCLUSIONS OF LAW

1. The Arizona Corporation Commission is a constitutionally created agency with authority to promulgate orders, rules, and regulations regarding the methodology of establishing the rates charged by public service corporations pursuant to Article XV of the Arizona Constitution and A.R.S. Title 40.

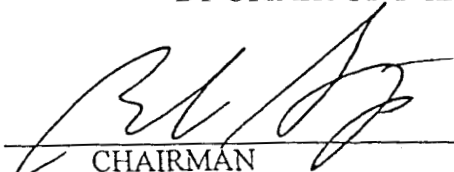

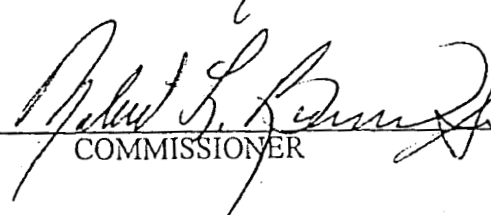

2. It is in the public interest to adopt the attached Revised Policy Statement to guide the ratemaking treatment of income taxes for tax pass-through public service corporations.

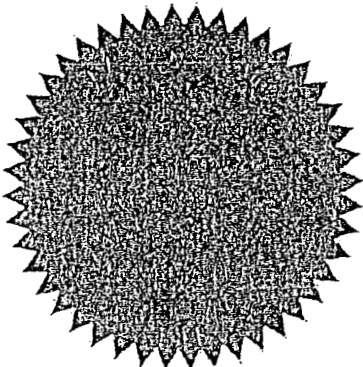
ORDER

IT IS THEREFORE ORDERED that the revised policy statement regarding the ratemaking treatment of income tax expense for tax pass-through entities is hereby adopted.

IT IS FURTHER ORDERED that this decision shall become effective immediately.

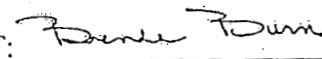
BY ORDER OF THE ARIZONA CORPORATION COMMISSION

 CHAIRMAN
 COMMISSIONER
 COMMISSIONER
 COMMISSIONER



IN WITNESS WHEREOF, I, JODI JERICH, Executive Director of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capital, in the City of Phoenix, this 21st day of February, 2013.


 JODI JERICH
 Executive Director

DISSENT: 

DISSENT: _____

1 SERVICE LIST FOR: DOCKET NO. W-00000C-06-0149

2 Michael W. Patten
 Timothy Sabo
 3 Roshka Dewulf & Patten
 One Arizona Center
 4 400 E. Van Buren, Suite 800
 Phoenix, AZ 85004

5 Court Rich
 6 Rose Law Group, PC
 6613 N. Scottsdale Rd., Ste. 200
 7 Scottsdale, Arizona 85250

8 Rick Fernandez
 25849 W. Burgess Lane
 9 Buckeye, Arizona 85326

10 Garry D. Hayes
 The Law Offices of Garry D. Hayes, PC
 11 1702 East Highland Avenue, Suite 204
 Phoenix, Arizona 85016

12 Greg Patterson
 13 Water Utility Association of Arizona
 916 W. Adams, Suite 3
 14 Phoenix, AZ 85007

15 Robert W. Geake
 Arizona Water Company
 16 P.O. Box 29006
 Phoenix, AZ 85038

17 Bryan O'Reilly
 18 SNR Management, LLC
 50 South Jones, Ste. 101
 19 Las Vegas, NV 89107

20 Mr. John Hackney
 Wells Fargo Securities
 21 301 South College Street
 MACD 1053-056
 22 Charlotte, North Carolina 28288

23 Daniel W. Pozefsky
 24 Chief Counsel
 RUCO
 25 1110 West Washington Street, Ste. 220
 Phoenix, Arizona 85007

Michele Van Quathem, Esq.
 Ryley Carlock & Applewhite
 One North Central Avenue, Ste. 1200
 Phoenix, AZ 85004

Court S. Rich
 M. Ryan Hurley
 Rose Law Group, PC
 6613 North Scottsdale Road, Suite 200
 Scottsdale, Arizona 85250

Jeffrey W. Crockett, Esq.
 Brownstein Hyatt Farber Schreck, LLP
 40 North Central Avenue, 14th floor
 Phoenix, Arizona 85004

Brian Thompsett
 Executive Vice President
 Johnson Utilities, LLC
 5230 East Shea Boulevard, Suite 200
 Phoenix, Arizona 85254

Herb Guenther
 ADWR
 3550 N. Central Ave
 Phoenix, AZ 85012

Paul Gardner
 Water Utilities Assoc. Of Arizona
 22713 S. Ellsworth Rd., Building A
 Queen Creek, AZ 85242

Richard L. Sallquist, Esq.
 Sallquist, Drummond & O'Connor, P.C.
 1430 East Missouri Ave., Ste. B-125
 Phoenix, AZ 85014-2467

Craig Marks
 AZ-AMERICAN WATER CO.
 2355 West Pinnacle Peak Road, Suite 300
 Phoenix, Arizona 85027-1282

Jim Poulos
 ROBSON COMMUNITIES, INC.
 9532 E. Riggs Road
 Sun Lakes, AZ 85248

1 Graham Symmonds
2 CTO & SVP-Regulatory Affairs &
3 Compliance
21410 N. 19th Ave., Ste. 201
Phoenix, AZ 85027

4 Thomas H. Campbell
5 Michael T. Hallam
6 LEWIS & ROCA, LLP
40 N. Central Ave.
Phoenix, AZ 85004

Thomas M. Broderick
Director, Rates & Regulation, American Water
2355 W. Pinnacle Peak Rd., Ste. 300
Phoenix, AZ 85027

Joseph D. Harris
Vice President and Treasurer
Arizona Water Company
P.O. Box 29006
Phoenix, AZ 85038-9006

ATTACHMENT 1

Policy Statement on Income Tax Expense for Tax Pass-Through EntitiesRevised 2/8/13

In several recent rate cases,¹ the Arizona Corporation Commission ("Commission") has been asked to impute income tax expense in the cost of service of so-called tax pass-through entities such as limited liability companies, Subchapter S corporations and partnerships. In each of these proceedings, the applicants presented testimony and evidence to the Commission supporting their request for including income tax expense. On the basis of this testimony and evidence, some commissioners expressed interest in reconsidering the income tax issue. In a Staff Meeting held January 12, 2011, the commissioners directed Utilities Division Staff to examine the merits of allowing income tax expense for tax pass-through entities in the generic docket captioned In the Matter of the Commission's Generic Evaluation of the Regulatory Impacts from the Use of Non-traditional Financing Arrangements by Water Utilities and their Affiliates.² A workshop was subsequently publicly noticed by Utilities Division Staff and held on March 25, 2011. Various participants in the generic docket made presentations, which were filed with Docket Control, addressing the arguments for and against including income tax expense in the cost of service of tax pass-through entities.

Because some commissioners were interested in reconsidering the question of imputed income tax expense, in early 2011 the Commission began to include an ordering paragraph in its rate case decisions for tax pass-through entities which recognized the possibility that the Commission might change its practice on the issue, and which specified a process for an affected utility to obtain a prospective increase in its revenue requirement through the filing of a petition under A.R.S. § 40-252 in the event the Commission did change its policy on imputed income tax expense. For example, the Commission included the following language in Decision 72177 (February 11, 2011) from the last Sahuarita Water Company rate case:

IT IS FURTHER ORDERED that in the event the Commission alters its policy to allow S-corporation and LLC entities to impute a hypothetical income tax expense for ratemaking purposes, Sahuarita Water Company, LLC may file a motion to amend this Order prospectively, and Sahuarita Water Company, LLC's authorized revenue requirement hereunder, pursuant to A.R.S. § 40-252, to reflect the change in Commission policy.³

¹ Sunrise Water Co. (Docket No. W-02069A-08-0406), Farmers Water Co. (Docket No. W-01654A-08-0502), Johnson Utilities, LLC (Docket No. WS-02987A-08-0180), Sahuarita Water Company, LLC (Docket No. W-03718A-09-0359), and Pima Utility Company (Docket Nos. W-02199A-11-0329 and W-02199A-11-0330).

² Docket W-00000C-06-0149.

³ Decision 72177 at 45-46.

There are a number of states which allow income tax expense in the cost of service for tax pass-through entities. For example, in *Suburban Utility Corporation v. Public Utility Commission of Texas*, 652 S.W.2d 358 (1983), the Supreme Court of Texas held that recognition of income tax expense for tax pass-through entities is necessary:

"The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried on by a corporation. Their elimination from cost of service is no less capricious than the excising of salaries paid to a utility's employees would be. We therefore hold that Suburban [a Subchapter S corporation] is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less."⁴

Based upon the evidence and testimony which has been presented in the recent rate cases before this Commission as well as the generic docket, we are persuaded that a tax pass-through entity should be allowed to recover income tax expense as a part of its cost of service and that its revenue requirement should be grossed up for the effect of income taxes. We are persuaded that the failure to include income tax expense needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. Neither of these outcomes serves the interests of rate payers. Thus, we hereby adopt a new policy which allows imputed income tax expense in the cost of service for limited liability companies, Subchapter S corporations and partnerships. While sole proprietorships are not technically tax pass-through entities, the arguments supporting the inclusion of income tax expense for tax pass-through entities are equally applicable in the case of sole proprietorships. Thus, the policy will apply to sole proprietorships as well as tax pass-through entities.

This new policy will be applied in pending and future rate cases. Also, companies that have been denied recognition of income tax expense in the past may make a filing under A.R.S. § 40-252 to modify the revenue requirement authorized in their most recent rate case order to include income tax expense prospectively from the date of an order of the Commission approving the A.R.S. § 40-252 filing.

We also desire at this time to provide guidance regarding how income tax expense for tax pass-through entities will be calculated in a fair and balanced way. We agree with the Supreme Court of Texas that the income tax expense for a tax pass-through entity should never be greater than it would be if the utility was a stand-alone C Corporation. Accordingly, tax expense will be determined as follows:

⁴ 652 S.W.2d at 364.

1. Identify all taxable persons or entities and all non-taxable entities⁵ (if any) which are owners of the tax pass-through entity. If the tax pass-through entity has an owner which is itself a tax pass-through entity, identify all taxable persons or entities and all non-taxable entities (if any) of such tax pass-through owner. Income tax expense shall be permitted based only upon the effective income tax rates of owners which have actual or potential state and federal income tax liability. The owner or owners of a tax pass-through entity shall not be required to submit personal income tax returns to the Commission, but shall submit documentation showing all owners of the tax pass-through entity, the respective ownership percentages of each owner, and the tax status of each owner (i.e., whether the owner is a taxable entity or a non-taxable entity).
2. Identify the tax filing status (ie. Married filing jointly, married filing single, single, etc.) of the individuals and entities from step 1 above.
3. Compute the actual effective income tax rate for each owner of the tax pass-through entity based upon such owner's proportionate share of taxable income at the proposed revenue level using applicable statutory federal and state income tax rates.
4. Calculate a weighted average effective income tax rate for the combined ownership of the tax pass-through entity.
5. Use the weighted average effective income tax rate for calculating the income tax allowance.
6. Also, calculate the income tax allowance (federal and state) for the tax pass-through entity as though it were a stand-alone Subchapter C corporation.
7. The authorized income tax allowance for the tax pass-through entity shall be the lower of: (i) the income tax allowance using the weighted average effective tax rate for the combined ownership calculated using steps 1 through 5 above; and (ii) the income tax allowance assuming the tax pass-through entity is a stand-alone Subchapter C corporation calculated using step 6 above.

⁵ Non-taxable entities are not-for-profit corporations, municipal corporations or other entities which do not have actual or potential state or federal income tax liability.

COMMISSIONERS
BOB STUMP - Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
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BRENDA BURNS
COMMISSIONER

Direct Line: (602) 542-0745
Fax: (602) 0765
E-mail: Burns-web@azcc.gov

**ARIZONA CORPORATION
COMMISSION**

February 21, 2013

Re: Policy Statement on Income Tax Expense for Tax Pass-Through Entities
Docket No. W-00000C-06-0149

Dissent by Commissioner Brenda Burns

I have not been persuaded that the Commission's constitutional duty to set "just and reasonable" rates should include the recovery of a utility shareholder's personal income taxes. "Just and reasonable" rates allow a utility to recover the expenses of a utility plus an opportunity to make a fair profit on its investment. Asking ratepayers to pay personal income taxes for shareholders of utilities organized as subchapter "S" corporations or limited liability corporations (LLCs) (aka "pass-through entities") is neither justifiable nor good public policy. Personal income taxes are not a utility expense.

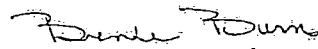
It is my obligation to consider the interests of both the utility and ratepayers. I do not feel this decision strikes the right balance. There are many ways to ensure that utilities receive a fair amount of revenue to cover its prudently incurred expenses but requiring ratepayers to pay a shareholder's personal income taxes is not a proper solution. Therefore, I must dissent.

Currently, all C corporations are treated equally and all pass-through entities are treated equally. Utilities voluntarily organize as pass-through entities or C corporations for a variety of reasons. Evidence has been presented that shows many utilities have chosen to be pass-through entities because of the tax advantages, including avoidance of the 'double-taxation' faced by C corporations.

However, C corporations and pass-through entities are not treated on equal footing because they are fundamentally different from each other. Ratepayers do not reimburse a C corporation's shareholders for their personal income taxes. This policy change requires ratepayers to reimburse shareholders of pass-through entities for their personal income taxes even though no tax was paid by the company itself.

Indeed, there are necessary water industry reforms that the Commission should examine. I am concerned with how water companies can ably deal with issues such as increased expenses, arsenic remediation requirements, under-recovery of authorized revenues, aging infrastructure and needs for new wells. However, this Decision may result in higher rates for many ratepayers but it does little or nothing to address those issues and may even harm the debate on these potential water utility reforms.

While I do believe that utilities must be compensated for just and reasonable expenses I do not believe this Decision sets a policy that does so in a fair manner.


Brenda Burns
Commissioner

Decision No. 73739

ORIGINAL

OPEN MEETING AGENDA ITEM



0000142236

BEFORE THE ARIZONA CORPORATION COMMISSION

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2013 FEB 11 P 12: 25

Arizona Corporation Commission

DOCKETED

FEB 11 2013

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IN THE MATTER OF A POLICY STATEMENT
ON INCOME TAX EXPENSE FOR TAX PASS
THROUGH ENTITIES.

Docket No. W-00000C-06-0149

RUCO'S COMMENTS

The Residential Utility Consumer Office ("RUCO") files these comments in response to the Commission's consideration of a Policy Statement that would change the current policy to allow tax recovery for pass-through entities.

I. INTRODUCTION

RUCO urges the Commission to not change its current policy which excludes the recovery of income taxes to pass-through entities (S Corporations and LLCs). Simply stated, a Commission policy which would allow pass-through entities to recover from ratepayers taxes that these utilities do not pay is bad public policy.

Commissioner Pierce submitted a draft policy statement ("draft policy") to stakeholders on June 15, 2012. The draft policy expressed numerous concerns with the current policy claiming that it "needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. Neither of these outcomes serves the interests of ratepayers." With all due respect each one of these

1 concerns is empty, and changing the current policy would not serve the ratepayer's
2 interests.

3 Among other things, a change in the current policy will unquestionably raise
4 ratepayer's rates and result in unintended consequences. At a time when the Commission
5 has its hands full dealing with the public perception of its energy efficiency and renewable
6 energy policies, RUCO hopes that the Commission will give serious consideration to the
7 public perception of a new policy that will result in higher rates because ratepayers will be
8 required to pay a utilities taxes that the utility does not pay.

9
10 **II. THE CURRENT POLICY DOES NOT DISCRIMINATE BECAUSE PASS-**
11 **THROUGH CORPORATIONS ARE NOT THE SAME AS C CORPORATIONS.**

12 The LLC/S Corporations and the C corporations are two different types of corporate
13 entities for tax purposes and the Commission should not treat them as if they are the
14 same. The LLC and S Corporation do not pay income tax and elect that form of
15 organization to avoid double taxation. The C Corporation does pay income tax and elects
16 that form of organization for other reasons such as avoiding the maximum shareholder
17 requirement of the S corporation. Trying to treat these two different forms of corporate
18 organization the same is as Commissioner Brenda Burns once said "trying to fit a square
19 peg in a round hole".

20 Ironically, in the draft policy's quest for parity, the result of a policy change will be
21 even more disparity – in both cases the investors would provide capital resulting in utility
22 operating income, but only the C corporation will pay the income taxes on the operating
23 income prior to distributing dividends to its investors who will then pay income taxes on
24 those dividends.

1 If one were to believe that the current policy "needlessly discriminates"- surely the
2 solution would not be to implement a policy that will "needlessly discriminate" against C
3 corporation shareholders (i.e. C Corp. shareholders do not currently recover their personal
4 income taxes from ratepayers) – two wrongs do not make a right. But more importantly,
5 how is it that the current policy that does not reimburse the S Corporation for income taxes
6 it does not pay by its own election, but does allow recovery to a C corporation for income
7 taxes it does pay discriminate in any way, shape or form? Actually it is the draft policy
8 that would discriminate. Hence, an unintended but very real consequence of the draft
9 policy will be that the C Corporations will request that their shareholder's be reimbursed for
10 the personal income taxes they pay. This will undoubtedly put the Commission in a very
11 tight spot – for how can the Commission then distinguish the two situations?

12 Another reason why the two are not the same concerns Accumulated Deferred
13 Income Tax ("ADIT"). When a C Corporation comes in for rate relief, there is an ADIT
14 calculation associated with the corporate income tax. ADIT, which typically is booked as a
15 liability, is also a deduction to ratebase. A deduction to ratebase benefits the ratepayers.
16 With S corporations, an ADIT calculation is not necessary since there is no corporate
17 income tax. The Commission's new policy will impute an income tax based on the
18 shareholder's personal income tax which will ignore ADIT¹ as the calculation is made
19 solely for the purpose of ascertaining the shareholder's recovery of personal income tax
20 from ratepayers and not to ascertain corporate income tax liability. Ratepayer's will get the
21 short end of the stick again.

23 ¹ The ADIT calculation in a newly filed rate case will apply prospectively since a Company will not have
24 collected any income taxes in rates in the past as an S corporation or an LLC. Nonetheless, it still remains a
valid concern.

1 **III. THE CURRENT POLICY DOES NOT CREATE AN ARTIFICIAL IMPEDIMENT TO**
2 **INVEST IN UTILITY INFRASTRUCTURE IN ARIZONA.**

3 The draft policy purports to stimulate growth but there is no evidence that the
4 current policy acts as an impediment to growth. To the contrary, since the 1980s when the
5 Commission established its policy to deny recovery of personal income taxes of
6 shareholders of pass-throughs, there has been an increase in the number of utilities
7 switching to or organizing as pass-throughs. Particularly after the passage of Tax Reform
8 Act of 1986, utilities have chosen to take advantage of the tax benefits afforded by S
9 corporations and LLCs.

10 Arizona water/wastewater utilities have experienced phenomenal customer growth
11 in the last few decades. The need for additional infrastructure has been a challenge.
12 Additionally, water utilities have had to comply with the federal Safe Drinking Water Act,
13 the Arizona Groundwater Code, and tougher EPA arsenic standards. Arizona's utilities
14 have risen to the challenge and have done so without changing their corporate status.
15 Some utilities, like Pima are built out, so it is difficult to appreciate the argument that
16 allowance of recovery of personal income taxes will incent needed infrastructure when
17 those utilities were able to meet the infrastructure demands when the challenge was the
18 greatest without choosing to change their corporate status.

19 The Commission's policy will not spur investment in Arizona. The S corporation
20 status allows utilities to avoid double taxation – paying corporate income taxes on
21 revenues and also personal income taxes on the after-tax dividends. It allows start-ups to
22 raise capital and lower their capital needs which even Pima's Senior Vice President and
23
24

1 Chief Financial Officer, Mr. Steven Soriano explained was a benefit in the Pima case.²
2 These benefits are the attraction of organizing as an S corporation, not the Commission's
3 policies.

4
5 **1. THE CONCERN THAT PASS-THROUGHS WILL SWITCH TO C**
6 **CORPORATIONS AND RATEPAYERS WILL PAY HIGHER TAXES IS**
7 **ANOTHER EMPTY CONCERN.**

8 Related to the investment argument is the concern that if utility customers do not
9 cover the pass-through shareholders personal tax liability, then the pass-throughs will elect
10 to reorganize as a C corporation. The maximum corporate income tax rate is higher than
11 the maximum individual income tax rate. A C corporation is subject to corporate income
12 tax. The concern is that since the maximum corporate income tax rate is higher than the
13 individual income tax rate, the ratepayers would pay even higher rates if the rates included
14 recovery for corporate income taxes rather the personal income taxes.

15 **A. THE COMMISSION NEED NOT CHANGE ITS POLICY TO**
16 **ATTRACT INVESTORS.**

17 In the Pima case, former Commissioner Spitzer explained why on the FERC level
18 there was a need to attract investors. Mr. Spitzer noted that the gas pipelines were
19 desperately needed throughout the country, and the investment community had made it
20 clear that they did not want to invest in the C corporations - they wanted to invest in the
21 pass-through corporations. FERC's intent was to encourage investment in desperately
22 needed gas pipelines.

23 In Arizona, there is a completely different set of circumstances. With many water
24 utilities, such as Pima, the utility is built out so infrastructure investment is not a concern.

² See Direct Testimony of William Rigsby at 6 in Docket No. W-02199A-11-0329.

1 Second, with FERC the question centered on desperately needed gas pipelines. In
2 Arizona, the concern is water, not gas pipelines, and there is no air of desperation. Finally,
3 there is no evidence that the Commission's current policy has pushed investors to C
4 corporations. In fact, according to Mr. Spitzer, the evidence would indicate otherwise. Mr.
5 Spitzer testified that most new entities are formed as pass-through LLCs. At the time Mr.
6 Spitzer was an Arizona Commissioner, he testified that the ratio was approximately 100 to
7 1 and has probably gotten larger³. When asked if he was aware of any entities organized
8 as a C corporation because of the Commission's policy he testified that he was not aware
9 of any⁴.

10 Mr. Spitzer's testimony is consistent with Staff's witness, Mr. Carlson who also
11 testified that he had no knowledge of utilities converting to C corporations because of the
12 Commission's long standing policy and could not even recall a single entity organized as
13 an S corporation that converted to a C corporation⁵. The concern is unfounded because
14 S Corporations provide the major benefit of avoiding double taxation which remains
15 regardless of the Commission policy. Pima is a prime example of a pass-through utility
16 that has not changed its corporate status since the mid-80s in spite of the Commission's
17 policy because of the tax advantages implicit with its pass-through status.

18

19 IV. THE DRAFT POLICY WILL RAISE RATEPAYERS RATES SIGNIFICANTLY.

20 The effect on ratepayers of the draft policy will be to raise their rates significantly in
21 most cases. At the Commission's Open Meeting held on July 19, 2012, RUCO discussed
22 with the Commission the effect of such a policy. In response to then Commissioner
23

24

³ See Transcript of Hearing in the Pima case at 186, Docket No. W-02199A-11-0329.

1 Newman's comments about how such a policy would raise rates, RUCO explained that at
2 that time there were at least three utilities, Johnson, Sahuarita, and Sunrise that were likely
3 waiting to file 252 applications and one utility, Pima, which at that point had a pending rate
4 application seeking pass-through recovery of income taxes⁶. Based on the filings of the
5 four companies, RUCO had determined that a change in policy would have the combined
6 effect on a total of 40,000 customers of over \$2,000,000 in increased cost. Moreover, a
7 change in policy will undoubtedly result in requests from other Arizona pass-through
8 Company's for the recovery of income taxes including Saddle brook (4,800 customers),
9 Sunrise, Tonto Creek, and Naco Water and on and on. The draft policy will result in a lot
10 of ratepayers in Arizona seeing their rates increase to allow utilities to recover income
11 taxes those utilities do not even pay.

12 **V. THE DRAFT POLICY IS LIKELY TO HAVE UNINTENDED CONSEQUENCES.**

13 **1. INCREASING RATES TO COVER SHAREHOLDERS' PERSONAL**
14 **INCOME TAX LIABILITY MAY RESULT IN AN UNJUST ENRICHMENT**
15 **TO SHAREHOLDERS IF NO TAXES ARE ACTUALLY OWED.**

16 As mentioned above, the shareholders of the C Corporation will undoubtedly
17 complain that the new policy discriminates against them. Another unintended consequence
18 concerns the tax imputation. Since shareholders may offset tax liability for income earned
19 with losses from other S corporations or other investments as well as other deductions,
20 credits and exemptions, it is quite possible that monies collected for the shareholders' tax
21 liability will exceed the amount of tax actually owed. For example, a shareholder of a

22 ⁴ See Transcript of Hearing in the Pima case at 186 - 187, Docket No. W-02199A-11-0329.

23 ⁵ See Transcript of Hearing in the Pima case at 308, Docket No. W-02199A-11-0329.

24 ⁶ Since the Open Meeting Pima's application has been decided and Pima has chosen to wait until the
Commission decided its policy before moving forward on this issue - see Decision No. 73573.

1 profitable S corporation utility who also realized losses from ownership of a real estate
2 development business can apply those losses to offset earnings derived from the utility.
3 Additionally, a shareholder can apply numerous exemptions, deductions and tax credits
4 that are available to the individual taxpayer but not to a corporation. Examples include
5 exemptions for minor children, deductions for health savings accounts, moving expenses,
6 student loan interest, child tax credit, dependent care tax credit, residential energy credits,
7 and retirement savings credit.

8 The result would be essentially free money for the shareholders paid by the
9 ratepayers who receive no benefit from these payments.

10
11 **A. IF THE COMMISSION DECIDES TO CHANGE THE POLICY,
12 THE COMMISSION SHOULD IMPUTE TAX RECOVERY BASED
ON SHAREHOLDERS ACTUAL INCOME TAX LIABILITY.**

13 There is no manner in which a system could be developed that would guarantee
14 that ratepayers would pay the appropriate amount of income tax. The taxable income for a
15 C corporation is based on the net income from the business. Taxable income for the
16 individual is based on the transfer of income in any number of ways including salaries,
17 interest, dividends, supplemental income, etc. The individual income tax rate will be the
18 same for all of those income sources with no preferential tax treatment for any source in
19 particular. There is no fair way to reconcile the shareholder's personal income tax with a
20 corporate income tax rate that will guarantee that ratepayers will pay an appropriate and
21 fair amount of income tax. As Staff recently acknowledged, about the best we can do is
22 "damage" the ratepayer as little as possible⁷.

23 ⁷ See the testimony of Staff's witness, Daryl Carlson in the recent Pima Utilities case. Transcript at 326 – 327.
24

1 If the Commission changes the policy, RUCO recommends that the tax imputation
2 be based on the actual taxes paid, and not a theoretical tax amount. The Commission
3 itself argued before the Arizona Court of Appeals in the *Consolidated* case that "The issue
4 of taxes that are actually paid dominates in states which have authorized inclusion of
5 income taxes even for entities that do not directly incur income taxes."⁸ The Commission
6 made this argument to show that a theoretical tax allowance would be arbitrary and
7 inappropriate. See attached excerpt of the Commission's Brief in the *Consolidated* case.

8 RUCO would not recommend that the Commission consider basing the imputation
9 on federal and state statutory income tax rates. In reality, the vast majority of individuals
10 pay an effective tax rate after deductions and adjustments. Their effective tax rate in most
11 cases is always below the statutory rate.

12 If the Commission approves the draft policy, RUCO would recommend that the
13 Commission adopt Staff's alternative methodology of imputation in Staff's Supplemental
14 Staff Report dated June 27, 2012.

15
16 **VI. THE CONSTITUTION'S DIRECTIVE TO SET JUST AND REASONABLE RATES
17 PRECLUDES THE INCLUSION OF UTILTY EXPENSES THAT DO NOT EXIST.**

18 RUCO believes that the Commission is prohibited by the Arizona Constitution from
19 setting rates that include shareholders' personal income tax liability. Neither the S
20 Corporation nor the LLC pays income taxes. Setting rates based on an operating expense
21 that does not exist will not result in just and reasonable rates. The Commission is required
22 to set just and reasonable rates under the Arizona Constitution. Ariz. Const. Art. 15, § 3.

23
24 ⁸ See Appellee Arizona Corporation Commission's Answering Brief at 29-33, *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 875 P.2d 137 Ariz.App. Div. 1, 1993, (September 07, 1993), 1 CA-CC 92-0002. The relevant excerpt of the Answering Brief is attached hereto as Attachment 1.

1 A change in policy will violate Arizona's Constitutional requirement to set just and
2 reasonable rates.

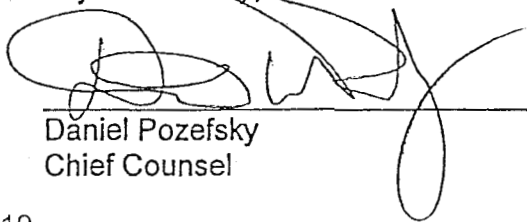
3 The Arizona Court of Appeals, at the Commission's request has upheld the current
4 policy. See *Consolidated Water Utilities, Ltd. v. Arizona Corp. Com'n*, 178 Ariz. 478, 484,
5 875 P.2d 137, 143, Ariz.App. Div. 1, 1993 (September 07, 1993). The Arizona Court of
6 Appeals rejected Consolidated's arguments to change the current policy made in the
7 course of several Consolidated cases. *In the Matter of Consolidated Water Utilities*,
8 Docket Nos. E-1009-86-216, E-1009-86-217, E-1009-86-332.) Decision No. 55839
9 (Docketed January 8, 1988). *In the Matter of Consolidated Water Utilities*, Docket Nos. E-
10 1009-90-115, E-1009-90-116 (decision No. 57666 (docketed December 19, 1991).

11 It took more than five years, and many battles for the Commission to settle in on the
12 current policy. The Court of Appeals decision made it clear that Arizona is not bound to
13 follow FERC or any state for that matter on the issue. The Court held that the Commission
14 set just and reasonable rates when it excluded recovery of personal tax expense. The
15 Commission, consistent with its prior decisions as well as the Arizona Court of Appeals
16 decision, should not change the current policy.

17 **VII. CONCLUSION**

18 For these and many other reasons, changing the current policy to allow pass-
19 through entities recovery of income tax that these entities do not pay is bad public policy –
20 period.
21

22 RESPECTFULLY SUBMITTED this 11th day of February, 2013.

23 
24 Daniel Pozefsky
Chief Counsel

1 AN ORIGINAL AND THIRTEEN COPIES
2 of the foregoing filed this 11th day of
February, 2013 with:

3 Docket Control
4 Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

6 COPIES of the foregoing hand delivered/
mailed this 11th day of February, 2013 to:

7 Lyn Farmer, Chief
8 Administrative Law Judge
Hearing Division
9 Arizona Corporation Commission
1200 West Washington
10 Phoenix, AZ 85007

11 Janice Alward, Chief Counsel
Charles Hains
12 Legal Division
Arizona Corporation Commission
13 1200 West Washington
Phoenix, AZ 85007

14 Steven M. Olea, Director
15 Utilities Division
Arizona Corporation Commission
16 1200 West Washington
Phoenix, AZ 85007

17 Thomas H. Campbell
18 Lewis and Roca LLP
40 North Central Avenue
19 Phoenix, AZ 85004

20 Thomas M. Broderick
Director, Rates & Regulation
21 American Water
2355 W. Pinnacle Peak Road, Suite 300
22 Phoenix, AZ 85027

Michelle Van Quathem
Ryley Carlock & Applewhite
One North Central, suite 1200
Phoenix, AZ 85004-4417

Graham Symmonds
21410 N. 19th Avenue, Suite 201
Phoenix, AZ 85027

Brian Tompsett
Johnson Utilities, L.L.C.
5230 E. Shea Blvd., Suite 200
Scottsdale, AZ 85254-5750
Jeffrey Crockett
One E. Washington St., Suite 2400
Phoenix, AZ 85004

Joseph Harris
Arizona Water Company
P.O. Box 29006
Phoenix, AZ 85038-9006

Court Rich
6613 N. Scottsdale Rd., Suite 200
Scottsdale, AZ 85250

Bryan O'Reilly
50 South Jones Blvd., Suite 1
Las Vegas, NV 89107

Gary Hays
1702 E. Highland Ave., Suite 204
Phoenix, AZ 85016

1 Michael T. Hallam
2 40 N. Central Ave.
3 Phoenix, AZ 85004

4 Timothy Sabo
5 Roshka, DeWulf & Patten, PLC
6 One Arizona Center
7 400 E. Van Buren St., Suite 800
8 Phoenix, AZ 85004

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11 By Cheryl Fraulob
12 Cheryl Fraulob
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DIVISION ONE

Appellee.

E-1009-90-115,
E-1009-90-116

APPELLEE'S ANSWERING BRIEF

Christopher C. Kempley
Assistant Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
Telephone: (602) 542-3402
Bar I.D. No. 005531
Attorney for Appellee

imposed what it recognized to be a hypothetical tax based on its understanding that an actual tax was paid, 412 P.2d at 850. The Suburban court notes that Moyston is the only decision of a court of last resort on the issue. After noting that the Public Utility Commission had recently approved the imputation of federal income tax liability for a Subchapter S utility, the Suburban court held "...that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less." 652 S.W.2d at 363, 364 (emphasis added).

The issue of taxes that are actually paid dominates in states which have authorized inclusion of income taxes even for entities that do not directly incur income taxes. While the Suburban case remains valid law in Texas, its effects have been somewhat mitigated. In Southern Union Gas Company v. Railroad Commission of Texas, 701 S.W.2d 277 (Tex.App. 3 Dist. 1985), the Texas Court of Appeals refined the Suburban doctrine somewhat, noting "...the Commission did not abuse its discretion in disallowing "theoretical" income tax liability for rate making purposes." 701 S.W.2d at 279. The Southern Union decision is cited approvingly by the Texas Supreme Court in Public Utility Commission of Texas v. Houston Lighting & Power Company, 748 S.W.2d 439 (Tex. 1987), in which theoretical income tax liability is also disapproved.

The most recent word on the topic of taxes actually paid is found in Kansas and it is particularly apposite in the current situation. In Greeley Gas Co. v. State Corporation Commission, 807

P.2d 167 (Kan.App. 1991), the Kansas Court of Appeals, while noting that Suburban appeared to still be good law in Texas, affirmed the Kansas Corporation Commission's disallowance of income taxes based on the utility's failure to produce the taxpayers income tax returns to demonstrate what income taxes were actually paid, if any, noting that the individual shareholders particular situation could cause the tax rate to vary across the various tax brackets that exist, 807 P.2d at 169, 170. In the current case, the issue of theoretical income taxes is squarely joined. Appellant asserts that their rebuttal evidence before the Commission provided evidence of an actual income tax obligation, Appellant's opening brief at page 39. Appellant also asserts that the witness upon whose testimony the income tax disallowance was based admitted that he would have allowed income taxes had Appellant been a corporation, Appellant's opening brief at page 33, citing TR. 446.

Appellant fails to do at least two things, however.

4 First, appellant fails to provide clear and satisfactory evidence of income tax amounts actually paid. The testimony cited by appellant indicates a calculation of income tax attributable to the operation of the utility. Without evidence of the actual payments made by the partners, no clear and satisfactory showing of unreasonableness of the Commission's order has been made, see Greeley, supra. Secondly, in addition to failing to demonstrate the actual amounts paid, appellant has not addressed the theoretical nature of the calculation of income tax it offered. Appellant mentioned the testimony at page 446 of the transcript on the topic of whether the witness would have allowed income taxes if it had been a corporation. Appellant failed to address the

ATTACHMENT C

COMMISSIONERS
BOB STUMP – Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH



SUSAN BITTER SMITH
Commissioner

ARIZONA CORPORATION COMMISSION

MEMO

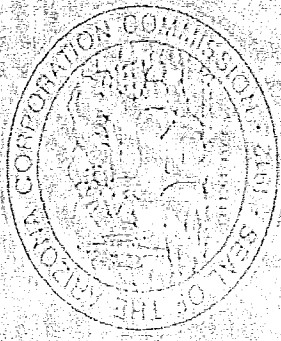
To: Arizona Corporation Commission, Docket Control

From: Office of Commissioner Susan Bitter Smith

Date: July 22, 2014

Re: Arizona Corporation Commission Generic Investigation in the matter of the Commission's inquiry into the possible development of regulatory policies and strategies to evaluate and potentially encourage consolidation concerning Arizona's water and wastewater utilities industry.
WS-00000A-14-0198

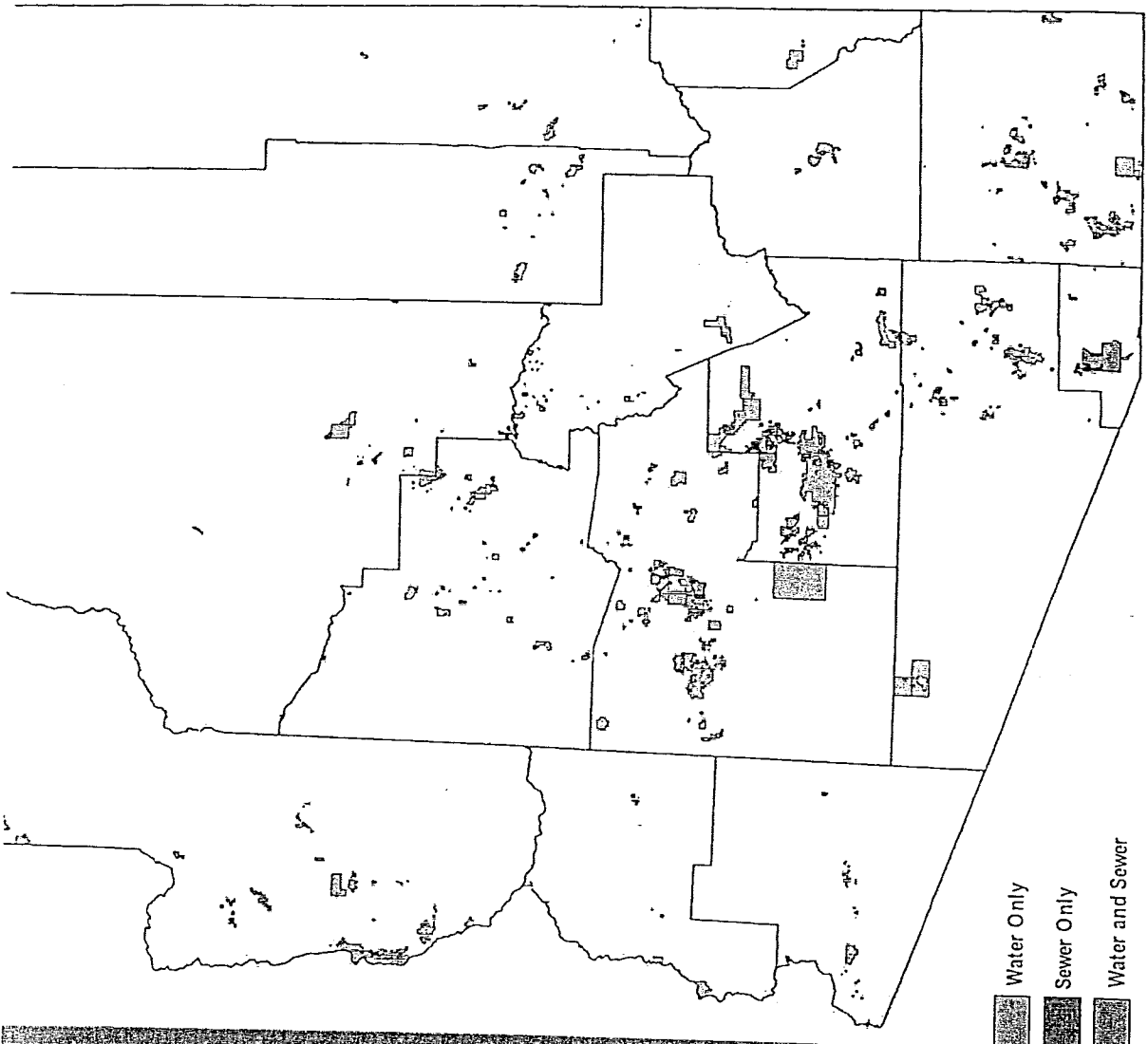
Commissioner Bitter Smith presented the attached presentation at the NARUC Summer Committee meeting in Dallas, TX on July 15, 2014.



ARIZONA CORPORATION COMMISSION

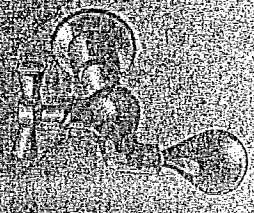
Acquisitions and Consolidations in Arizona's Water & Wastewater Industry

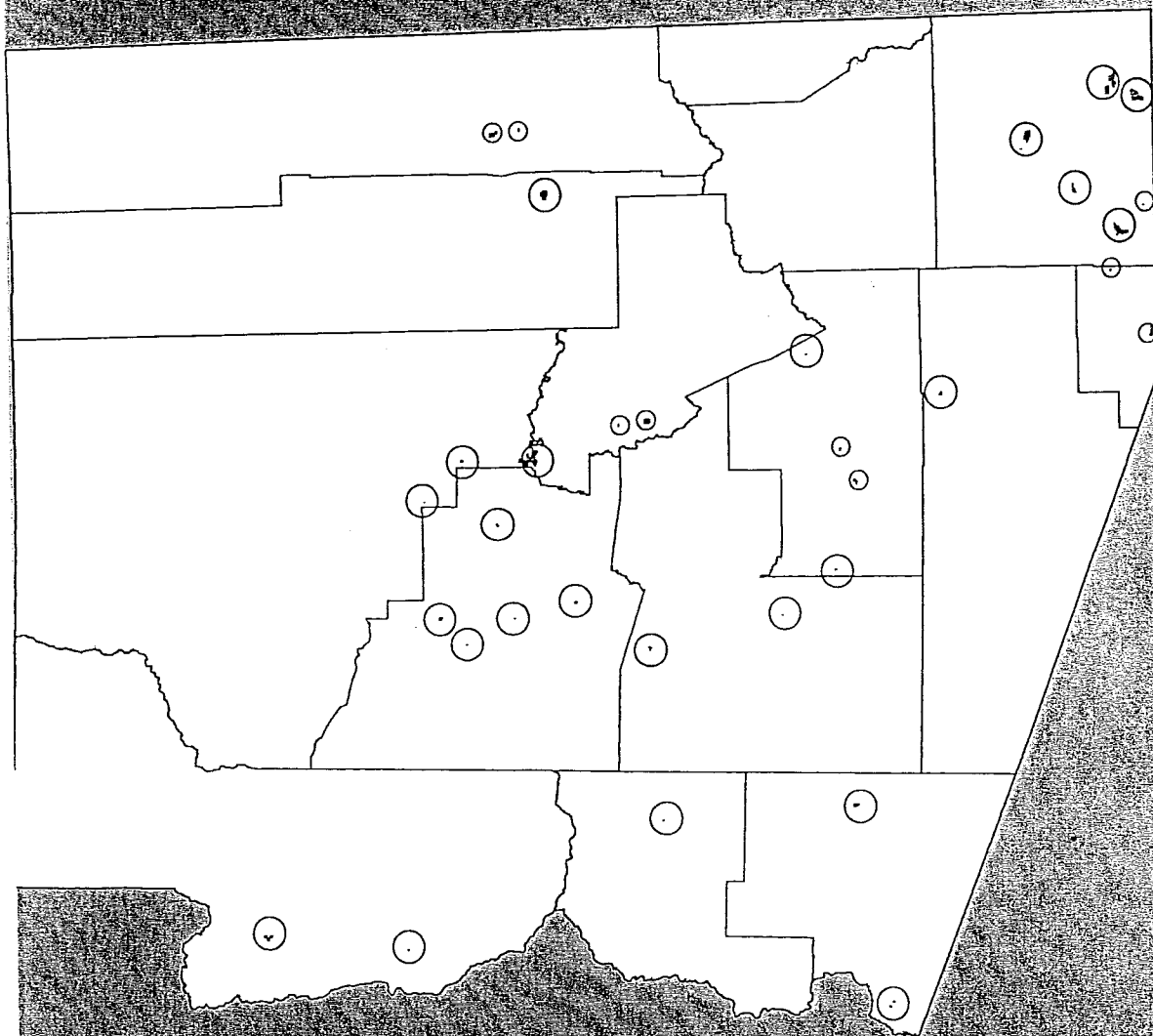
Presented by
Commissioner Susan Bitter Smith



STATE OF ARIZONA
WATER AND WASTEWATER COMPANIES
REGULATED BY THE
CORPORATION COMMISSION

- Water Only
- Sewer Only
- Water and Sewer





STATE OF ARIZONA
CHALLENGED WATER AND WASTEWATER
COMPANIES REGULATED BY THE
CORPORATION COMMISSION



“Reduce the number of small,
non-viable water systems
through new rules and procedures.”

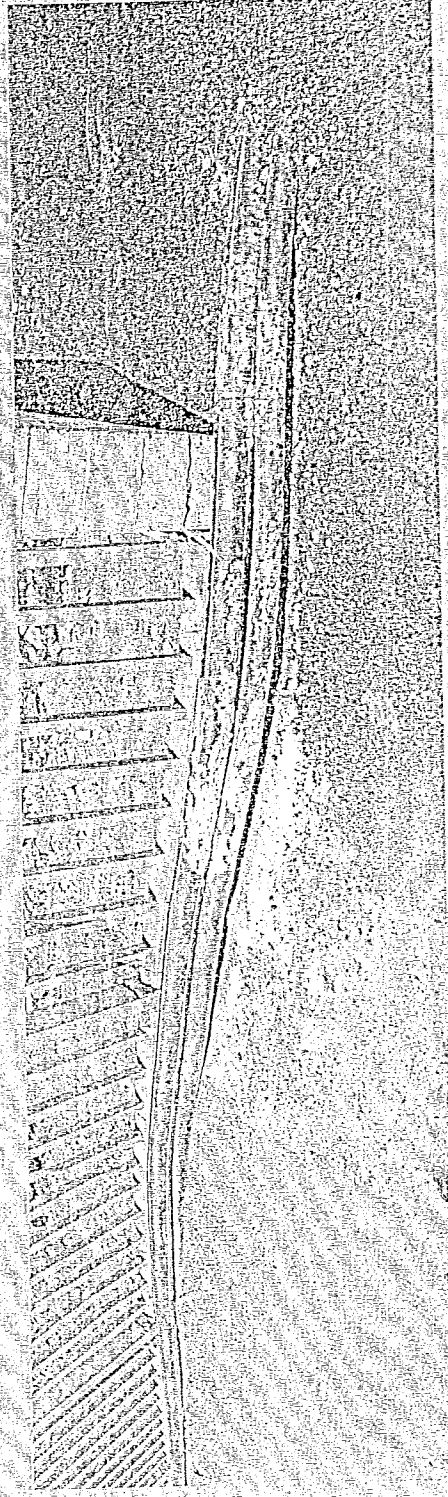
Interim Report of the Arizona Corporation Commission's Water Task Force,
October 28, 1999, Page 3 [Docket No. W-000000C-98-0153]

“Many of Arizona’s water companies are quite small; the majority of them have less than \$250,000 in annual revenues... Because of their small base of customers, even quality managers of small companies may find it difficult to raise sufficient revenues to make needed capital investments.”

Interim Report of the Arizona Corporation Commission’s Water Task Force,
October 28, 1999, Page 3 [Docket No. W-00000C-98-0153]

Attracting the interest of well managed and well financed acquisition partners will require a regulatory environment that recognizes that properly matching the level of financial and operational risk with the opportunity to earn a fair risk-adjusted rate of return is going to be a key to successful water and/or wastewater system consolidations.

The goal is to insure
Arizona ratepayers access to
safe and assured water supplies
at affordable prices-
A true balancing act!



ATTACHMENT D



RESIDENTIAL UTILITY CONSUMER OFFICE

www.azruco.gov

1110 WEST WASHINGTON • SUITE 220 • PHOENIX, ARIZONA 85007 • PHONE: (602) 364-4835 • FAX: (602) 364-4846

Douglas A. Ducey
Governor

David P. Tenney
Director

November 4, 2015

Timothy J. Sabo
Snell & Wilmer
One Arizona Center
400 E. Van Buren Street, Suite 1900
Phoenix, Arizona 85004

Re: Willow Valley Water Co., Inc. – First Set of Data Requests to RUCO –
Docket Nos. W-01303A-15-0131 and W-01732A-15-0131

Dear Mr. Sabo:

Enclosed are RUCO's Responses to Willow Valley Water Company's First Set of Data Requests.

If you have any questions, please contact me at 602-364-4839.

Sincerely,

A handwritten signature in dark ink, appearing to read "D. Pozefsky", written over a horizontal line.

Daniel W. Pozefsky
Chief Counsel

Enc.

RUCO responses to Global's data requests:

Willow 1.1 Please provide all work-papers associated with RUCO's testimony.

No schedules were used, all testimony and exhibits have been included in Mr. Michlik's testimony.

Willow 1.2 Admit that EPCOR Water Arizona Inc. has the management capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO's job is not to oversee or evaluate Company management capabilities to own and operate the Willow Valley system, nor is it prescribed in the Arizona administrative code. If the Company needs assistance in evaluating its management, financial, or technical capabilities, it can hire an outside consultant to resolve any issues it may have.

Willow 1.3 Admit that EPCOR Water Arizona Inc. has the financial capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.2. In addition, the Company objected to RUCO 4.03 which asked for updated financial information related to dividend payouts, not to mention most of the other financial data in this document is subject to a confidentiality agreement. So, even if the Commission were to ask RUCO to do some type of financial analysis to assess the Company's financial capability the Company would have to provide RUCO with this information.

Willow 1.4 Admit that EPCOR Water Arizona Inc. has the technical capability to own and operate the Willow Valley system. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.2.

Willow 1.5 List each decision of the Arizona Corporation Commission, of which RUCO is aware, where the Commission approved a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of RUCO Witness Michlik).

RUCO is not aware of any Commission approved regulatory liability for ADIT in an asset transfer.

Willow 1.6 To the knowledge of RUCO, list each prior docket where RUCO proposed a regulatory liability for ADIT in an asset transfer (as proposed in the testimony of RUCO Witness Michlik).

RUCO is not aware of any recommendations that it has made in the past regarding this issue at this juncture.

Willow 1.7 Admit that if a regulatory liability is created for ADIT (as proposed in the testimony of RUCO Witness Michlik), that BWAZ will be required to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules [§168(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l)-1 (together, Depreciation Normalization Rules)]. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO cannot admit or deny at this point as RUCO is researching this issue, and will supply a supplemental response at a later date.

Willow 1.8 Provide RUCO's calculation of the ratepayer impact if EWAZ is forced to use straight line depreciation for income tax purposes under the IRS Depreciation Normalization Rules (§68(i)(9) of the Internal Revenue Code of 1986, as amended (Code), and Treas. Reg. §1.167(l) - 1 (together, Depreciation Normalization Rules)). If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.7.

Willow 1.9 Regarding Attachment C to Mr. Michlik's Direct Testimony (Staff Memorandum dated June 29, 2015), admit that none of the proposed policy statements recommended in that memorandum were ever adopted as formal policy statements by the Commission. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO cannot admit or deny at this point as RUCO is researching this issue, and will supply a supplemental response at a later date.

Willow 1.10 Regarding the March 19, 2012 Commission Staff Memorandum attached to Mr. Michlik's Direct Testimony, admit that the Arizona Corporation Commission has not adopted the recommendations set forth in that memorandum. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

See RUCO response to Company data request Willow 1.09

Willow 1.11 Regarding the article on "Tolleson to get \$4.3M settlement in water treatment plant dispute" (Attachment D to Mr. Michlik's Direct Testimony), please provide the name of the publication this article appeared in, the date, and the page.

West Valley View, Friday, June 12, 2015 page 1.

Willow 1.12 Regarding Mr. Michlik's statement that the "legal disputes" referenced in Attachment D to his Direct Testimony "could affect the Company's financial viability". (Page 16, lines 17 to 19). Please provide the following:

- A. Mr. Michlik's financial analysis of how EPCOR Water Arizona Inc.'s financial viability could be impacted by the referenced legal disputes.
- B. Did Mr. Michlik review any other documents other than the news articles in Attachment D in researching the impact of these legal disputes on EPCOR Water Arizona Inc.?
 - (i) For example, Did Mr. Michlik review legal pleadings?
 - (ii) Did he review notes to financial statements regarding the litigation?
- C. Provide Mr. Michlik's analysis of EPCOR Water Arizona Inc.'s maximum financial exposure in these legal disputes.

RUCO's analysis is very simple, if the Company is still involved in a series of legal disputes, and has to pay out millions of dollars that means the Company has less money to invest in this water system.

Willow 1.13 Regarding Attachment F to Mr. Michlik's Direct Testimony, provide the following information:

- A. Any prior public versions of this document.
- B. Who compiled the document?
- C. When the document was compiled.
- D. Describe the methodology used to prepare the document.
- E. How many of these states have as many water companies as Arizona?

In response to B: The information was provided by the National Association of Water Companies ("NAWC").

RUCO does not have any information relating to questions A, C, D, or E. Since NAWC is the trade group that represents Global. RUCO suggests that the Company ask the questions to NAWC.

Willow 1.14 Regarding Mr. Michlik's statement that Global Water Resources, Inc. is a class A utility", [Michlik Direct at page 3, line 10-13 and page 16, line 12) admit that Global Water Resources, Inc. is a "Public Utility Holding Company" as defined in A.A.C. R14-2-801, and not a "Class A" utility as defined in A.A.C. R14-2-103. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

RUCO's classification was based on Staff's sufficiency letter dated November 7, 2012. Upon further review, RUCO agrees that Global Water Resources, Inc. is a Public Utility Holding Company.

Willow 1.15 Regarding Mr. Michlik's statement that Global Water Resources, Inc. is an Arizona corporation, admit that Global Water Resources, Inc. is a Delaware corporation. If your response is anything other than an unqualified admission, provide a complete description of the basis of your response, including stating each fact or document on which you based your response.

Global Water Resources, Inc. probably was incorporated in Delaware, and does business in Arizona, and has offices in the Phoenix Area. Further, from Global Water Resources website "Global Water Resources Corp (GWRC) was incorporated in British Columbia to acquire shares of U.S. based Global Water and to actively participate in the management, business and operations of Global Water through its representation on the board of directors of Global Water and its shared management of Global Water. GWRC owns an approximate 48.1% interest in Global Water."

Willow 1.16 Mr. Michlik's Direct Testimony states that "The Company's proposed acquisition adjustment seems very similar to a System Improvement Benefits ("SIB") Mechanism in which utility plant is built between rate cases. The Arizona Court of Appeals subsequently determined that the SIB was illegal (see Attachment A). This is basically the same situation in this case as the acquisition premium as proposed will create rate increases between rate cases without a fair value determination" (Michlik Direct at page 7, lines 12 to 18). If the SIB mechanism and EWAZ's proposed acquisition adjustment mechanism are illegal because they change rate base outside of a rate case, please explain how RUCO's proposed "ratepayer protection mechanism"

(Michlik Direct at page 20, lines 20-21), which reduces rate base outside a rate case, is legal.

RUCO believes the initial premise to the question is no longer valid. The Company has clarified or modified its proposed acquisition adjustment in which it states it will not ask for rates outside of a rate case, but will ask for the premium be recovered in a rate case (see Testimony of EPCOR witness Sarah Mahler), thus eliminating RUCO's concern over the fair value determination. RUCO's ratepayer protection mechanism does not adjust outside of a rate case – there is no fair value issue with RUCO's recommended treatment of the acquisition premium.

ATTACHMENT E

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK

Chairman

JIM IRVIN

Commissioner

WILLIAM A. MUNDELL

Commissioner

Arizona Corporation Commission

DOCKETED

NOV 03 2000

DOCKETED BY

RT

IN THE MATTER OF THE ARIZONA
CORPORATION COMMISSION'S OWN
MOTION TO ESTABLISH THE COMMISSION
WATER TASK FORCE

DOCKET NO. W-00000C-98-0153

DECISION NO. 62993

ORDER

Open Meeting
October 24 and 25, 2000
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On April 24, 1998, in Decision No. 60829, the Arizona Corporation Commission (Commission) established the Commission Water Task Force (Task Force). The Task Force consists of representatives of regulatory agencies, the water providers, and water consumers. On September 22, 1998, the Task Force held its first meeting. The Task Force meetings were all noticed Open Meetings.

2. On October 28, 1999, the Task Force completed its Report for the Commission (Report). The Report contains recommendations to the Commission on several issues facing Arizona's water industry. On many issues, the Task Force achieved consensus. On other issues, the Report contains different recommendations from the various Task Force members.

3. On January 5, 2000, the Task Force Report was docketed and distributed to every Arizona water company regulated by the Commission. A deadline of March 15, 2000, was set for comments on the Report to be filed. Only two water companies and the Central Arizona Project (CAP) submitted comments. Arizona Water Company generally supports the Staff's proposals, but does express some reservations. Lakewood Water Company, a small water company in Amado, indicates that it is currently struggling with the financial requirements to fund necessary capital improvements. The capital costs to make improvements would double the rates for the company's customers many of whom are low income. The company expresses interest in the possibility of

Decision No. 62993

1 consolidation with other water utilities. The CAP generally supports Staff's proposals, but it does
2 express some reservations.

3 4. The Task Force was divided into three subcommittees: the Regulatory Reform
4 Subcommittee, the Conservation Subcommittee, and the Water Supply Subcommittee. The Regulatory
5 Reform Subcommittee achieved consensus on five goals:

- 6 • Reduce the number of small, non-viable water systems through new rules and procedures.
- 7 • Strengthen the financial capacity of the water utility industry.
- 8 • Provide greater emphasis on simplifying, shortening, and reducing the cost of the
9 regulatory process.
- 10 • Improve consumer education.
- 11 • Increase interagency coordination.
- 12
- 13

14 5. The Conservation Subcommittee focused on developing policies the Commission could
15 use to encourage water conservation. The Water Supply Subcommittee focused on issues relevant to
16 renewable and surface water supply, such as the Central Arizona Project.
17 Regulatory Reform Subcommittee

18 6. On Pages 3 through 25 of the Report, the Regulatory Reform Subcommittee's
19 recommendations and discussions are summarized.

20 7. On Pages 4 through 7 of the Report, Staff's proposal on placing more stringent
21 requirements on approval of CC&Ns for new water companies is discussed.

22 8. Commission Staff recommended the following Commission policy changes concerning
23 the establishment of new water companies:

- 24 a. The application for a new CC&N must show that an existing water company cannot
25 or will not serve the area being applied for. This showing must be made by submitting
26 service rejection letters from all the "A" size water companies in the state (there are 3)
27 and at least five of the "B" size companies (there are 20). The five B size companies
28 contacted should include the B size companies that are geographically closest to the
29 applicant. The application must also be accompanied by service rejection letters
30

1 from all the existing water companies within five miles of the area being requested. In
2 addition, the rejection letters must be accompanied by the corresponding request for
3 service that was made to each of the existing water companies by the applicant.

- 4 h. The rates should be set such that the company should at least break even no later than
5 its third year of operation. The calculations would be based on the company's
6 reasonable estimates of customer growth. The company should also be required to
7 come . . . for a rate case three years after serving first permanent customer.
8 c. Because Staff believes that it is not in the public interest, no new CC&N would be
9 issued to any company that was affiliated with any other company or person that was
10 not in total or substantial compliance with Commission and ADEQ requirements. This
11 restriction should apply to CC&N extensions and transfers as well.
12 d. Staff recommends establishing a set of standard service charges for new CC&Ns.
13 e. Staff will work with the ADWR to establish tiered rate structures for new CC&Ns.

14 9. Staff recommends that the Commission endorse Staff's recommendations. Further,
15 Staff requests that the Commission order Staff to develop (through meetings with members of the
16 industry, RUICO, and other interested parties) a detailed statement of policy on water CC&Ns by
17 June 30, 2001. The detailed statement of policy should conform to the general principals of Staff's
18 recommendation contained in the Report and the above discussion. Staff members who are
19 responsible for processing new water CC&N requests should be responsible for conducting these
20 meetings and developing the detailed statement of policy

21 10. On Pages 8 through 11 of the Report several proposals for providing incentives for
22 consolidation in the water industry are discussed. Staff recommends that an acquisition adjustment
23 or a rate of return premium (but not both) be allowed under certain conditions. These conditions are:

- 24 • The acquisition is in the public interest;
25 • The acquisition will not negatively affect the viability of the acquirer;
26 • The acquired system's customers will receive improved service in a reasonable timeframe;
27 • The purchase price is fair and reasonable (even though that price may be more than the
28 original cost less depreciation book value) and conducted through an arms' length
negotiation;

- 1 • The recovery period for the acquisition adjustment should be for a specific minimum time
- 2 (e.g., twenty years); and
- 3 • The acquired company is a class D or E.

4
5 11. Staff does not recommend allowing for acquisition adjustments unless all of the above
6 conditions are met. Staff believes that the burden should be on the company to prove that an
7 acquisition adjustment or a rate of return premium is in the public interest. The public interest
8 determination should account for the capital investments needed for the customers to receive improved
9 service and the costs savings the company is likely to realize through economies of scale. Other
10 methods of encouraging consolidation include allowing for rate of return premiums and deferral
11 accounting orders. Staff recommends that the Commission endorse Staff's recommendation. Further,
12 Staff requests that the Commission order Staff to develop, through meetings with members of the
13 industry, RUCO, and other interested parties, a detailed statement of policy on acquisition adjustments
14 and rate of return premiums by June 30, 2001. The detailed statement of policy should conform to the
15 general principals of Staff's recommendation contained above and in the Report. Staff members who
16 are responsible for recommending approval or denial of acquisition adjustment requests should be
17 responsible for conducting these meetings and developing the detailed statement of policy.

18 12. Other incentives for consolidation could be provided by the State Legislature. Tax
19 breaks or credits could be provided to companies that choose to acquire small and/or financially non-
20 viable water companies. The Staff requests the Commission adopt recommendations to the Legislature
21 regarding incentives for consolidation and direct the Commission's Legislative Liaison to initiate
22 efforts to encourage the Legislature to adopt these incentives.

23 13. The establishment of a fund similar to the Universal Service Fund used for
24 telecommunications firms, is another option for improving the financial capacity of small water
25 companies. A fund that all water companies pay into and that financially strapped companies could
26 draw out of for infrastructure investments could be established. For fairness purposes municipal water

1 companies would need to be included as contributors/beneficiaries of the fund. This would require
2 legislation as well as changes to the Commission rules. Staff proposes this fund as an approach the
3 Commission may want to consider in the future.

4 14. Issues involving property taxes are discussed on Pages 12 and 13 of the Report. The
5 Staff requests the Commission adopt recommendations to the Legislature regarding alternative taxation
6 mechanisms for private water companies and direct the Commission's Legislative Liaison to initiate
7 efforts to encourage the Legislature to adopt these tax alternatives. Staff also recommends that the
8 Accounting and Rates (A&R) section of the Utilities Division sponsor, for any interested party, a
9 seminar on the ratemaking implications of property taxes, focusing on the problems the industry
10 outlines in the Report.

11 15. On Pages 14 and 15 of the Report, the Future Test Year issue is discussed. Staff
12 believes that there is no need to change the present method used by the Commission. At present, the
13 Commission employs an historical test year but does allow for pro forma additions for known and
14 measurable costs. It is Staff's opinion that this is a very good combination of both historical and future
15 test years. Presently, this is done on a case-by-case basis. Staff believes that this method could be
16 improved, therefore, Staff recommends that the Commission order Staff to develop a policy with
17 specific requirements for expense changes, revenue changes, and plant additions that occur after the
18 test year. Such items would include, but are not limited to:

- 19
- 20 a. Method of matching new expenses with new revenues.
 - 21 b. Revenue neutral plant, i.e., plant to serve existing, not future, customers.
 - 22 c. Revenue neutral plant will be installed within a specific timeframe, preferably one year.
 - 23 d. Revenue neutral plant is necessary to provide proper and adequate service to existing
24 customers.

25 16. On Pages 15 and 16 of the Report, Staff's recommended Generic Hook-up Fee policy
26 is outlined. Both the industry and RUCO support Staff's recommendation in principal. Staff believes
27 that implementing this recommendation will require a ratemaking proceeding. Staff requests that the
28

1 Commission order a rule making proceeding be opened to implement a Generic Hook-up Fee policy
2 along the lines of Staff's proposal.

3 17. On Pages 16 through 19 of the Report, proposals for plant replacement fund
4 mechanisms are discussed. Staff recommends that the Commission adopt a policy similar to the
5 Pennsylvania Public Utilities Commission's Distribution Service Investment Charge (DSIC). Staff
6 requests that the Commission order a rule making proceeding be opened to implement rules for a DSIC
7 or similar program in Arizona.

8 18. On Pages 19 and 20 of the Report, problems associated with past high depreciation
9 rates are discussed. The industry offered proposals on how to rectify these problems; however, Staff
10 and RUCO found those approaches to be inappropriate. Staff believes that its proposed Rate of Return
11 policy (discussed below) will solve the problems associated with past excessive depreciation rates. All
12 parties agreed that the Commission should no longer approve excessive depreciation rates for small
13 water companies.

14 19. On Pages 20 and 21 of the Report the pass-through mechanism approved by the
15 legislature in SB 1252 (now A.R.S. § 40-370) is discussed. The industry representatives on the Task
16 Force felt that the Commission's policy on A.R.S. § 40-370 needed to be clarified because, at the time
17 the Report was written, only one company had applied for authority to adjust rates under the provisions
18 of this mechanism. Since then the Commission has approved two such applications (they both have
19 been appealed). The two approved applications were for Arizona Water Company's Monitoring
20 Assistance Program (Decision No. 62141) and Rio Verde Utilities, Inc.'s CAP cost increase (Decision
21 No. 62037). Those two decisions indicate that the Commission's policy on A.R.S. § 40-370
22 applications is to support appropriate pass-throughs, which should mitigate the industries concerns.

23 20. On Pages 21 and 22 of the Report, Staff's proposed Rate of Return policy is outlined.
24 Staff believes that implementing this policy will solve the problems associated with high depreciation
25 rates and lead to other improvements. This policy would make filing rate cases much less burdensome
26 for small water companies. Staff's proposed policy allows companies that are filing rate applications
27 to choose between 1) a generic rate of return (for C, D, and E companies only); 2) setting rates based
28 on an operating margin basis (i.e., no rate of return consideration); or 3) an individual rate of return

(i.e., traditional rate making) In addition to the recommendations in the Report, Staff is recommending that the choice of the generic rate of return be limited to C, D, and E companies. Also, Staff recommends that the generic rate of return should be a minimum rate of return; thus, points can be added to it to account for special expenses such as WIFA loan payments. Staff requests that the Commission order a rule making proceeding be opened to implement Staff's proposed Rate of Return policy. Staff is aware that the recent Court of Appeals Opinion may impact the Commission's ability to implement Staff's proposed rate of return policy. Staff believes that the issues raised by the Court of Appeals Opinion are best dealt with during the rulemaking proceedings.

21. On Pages 22 and 23 of the Report, the electronic filing of annual Reports, rate cases, and other filings with the Commission is discussed. Staff, the industry, and RUCO all agreed that allowing for electronic filing would be beneficial. Staff has already initiated the first steps of this process by making the Short Rate Case Form available on the Commission's web site. Staff is committed to making all of its forms available electronically. In order to institute full electronic filing, the Hearing Division will need to be involved. Staff is committed to working with the Hearing Division to develop a process that will allow for full electronic filing.

22. During the Task Force's discussions of electronic filing, the industry also expressed concern about the volume and extent of the Commission's filing requirements. Staff acknowledges that certain filing requirements may be out-dated. Staff is currently reviewing all forms and filing requirements. However, such a review is a major undertaking and may take some time to complete.

23. On Page 23 of the Report, Staff's Main Extension Agreement (MXA) proposal is outlined. Staff's proposal is to have standard MXA provisions included in each water companies tariffs, instead of the current process of approving MXAs on an individual case basis. Both the industry and RUCO supported Staff on this issue. Staff requests that the Commission order a rule making proceeding be opened to implement Staff's proposed MXA policy.

24. On Pages 23 and 24 of the Report, several suggestions concerning consumer education are discussed. Staff is currently working on educational programs for all industries the Commission regulates. Implementing any educational program may require additional funds from the Legislature. Staff is also evaluating the expansion of its well-regarded Small Water Assistance Team (SWAT)

1 program (which deals with educating water company owners/operators) to include education for water
2 consumers.

3 25. On Pages 24 and 25 of the Report, Staff's Phased Rate Increase policy is discussed.
4 Staff believes that in certain limited circumstances it is appropriate to phase rate increases in over
5 time. Staff will develop well-defined guidelines for when and how phased rate increases are
6 appropriate.

7 26. On Page 25 of the Report, Staff's recommendation on rates tied to conditions is
8 discussed. Staff recommends that all rate increases be conditioned on the company providing
9 acceptable quality service, water quality, and other relevant conditions. Staff has already implemented
10 this policy informally by including specific conditions in recent Recommended Orders. Staff will
11 develop a standard set of conditions that could apply to all water companies. One impediment to this
12 policy being successful is the Commission's lack of enforcement resources. Currently, the Utilities
13 division has *one* compliance officer to handle *all of the utilities* the Commission regulates.

14 Conservation Subcommittee

15 27. On Pages 26 through 29 of the Report, the Conservation Subcommittee's
16 recommendations and discussions are described. On Pages 26 through 28, a perceived problem with
17 the Commission's conservation policy is discussed. The industry and consumer members of the Task
18 Force as well as the ADWR representatives believed that the Commission would not allow companies
19 to include the costs of conservation programs in rates unless the conservation program was mandated
20 by the ADWR. If this were true, it would discourage companies from engaging in conservation
21 programs. However, Staff does not believe that this is true. No member of the Task Force could site
22 any examples of instances where Staff has recommended denial of conservation program costs or
23 where the Commission approved an order that included the denial of conservation programs and their
24 reasonable costs. Staff supports and encourages conservation. Staff believes that recovery of any
25 reasonable costs for conservation programs should be allowed.

26 28. On Pages 28 and 29, Staff's proposal to institute three tiered rates is discussed. Tiered
27 rates are the Commission's only direct means of encouraging conservation. Both the industry and
28 RUCO opposed Staff's proposal. The industry claimed that it is sure to result in companies

underearning, while RUCO claimed the policy is sure to result in companies overearning. Staff believes that, as with any rate design, there is a possibility of either cost or overearning. However, if the company implemented a tiered rate design, it would have a chance of recovering its costs. If the company implemented a tiered rate design, the tiered rates would result in the non-conserving customers paying extra for large uses of water and reward those customers that used very little water. If customers conserved such that all were falling within the middle tier, the company should earn its allowed rate of return. If the customers continued to use water in the third tier, the water company would probably overearn. The use of the overearnings could be used to fund conservation programs or other water conservation programs. Staff realizes that this is a new and untested concept, but it is a new way of thinking about water conservation. But Staff also realizes that new ways have to be considered to save what many consider to be this State's most precious resource. Staff recommends that the Commission order Staff to consider tiered rate designs for all water company rate cases and that the tiers be designed to encourage conservation. Staff recognizes that tiered rates may not be appropriate in all cases and that the decision to use or not use tiered rates must be made on a case-by-case basis. Staff also recognizes that the appropriateness of tiered rates should be determined on a case-by-case basis. Finally, Staff proposes that the Commission order Staff to develop a detailed statement of policy on tiered rates by June 30, 2001.

18 Water Supply

29. On Pages 30 through 33 of the Report, the Water Supply Subcommittee's recommendations and discussions are summarized. The main focus of this subcommittee was the recovery of Central Arizonan Phosphate Company (CAP) water allocation costs (CAP costs). All members of the subcommittee agreed that the Commission should require the recovery of CAP costs in a proceeding independent of a rate case. However, the Commission's Legal division has concluded that considering CAP costs outside of a rate case would run counter to the recent Court of Appeals opinion on fair value. There was disagreement among the Subcommittee members about what the Commission should require before it allows for CAP cost recovery. In the Report, Staff recommended that the Commission allow for CAP cost recovery once the company has submitted a plan that includes a schedule for the recovery of CAP costs over a period of five years. Staff chose a

1 five-year time horizon because Staff wished to limit the extent to which current customers are charged
2 for CAP allocations which will only be used to serve future customers.

3 30. Since the Report was written, Staff has modified its position. Staff believes that the
4 time requirement placed on companies applying for CAP should be phased while
5 allowing cost recovery. Staff believes that the time requirement placed on companies applying for
6 CAP cost recovery should be decided on a case by case basis. Also, to ensure that current customers
7 do not pay an unfair amount relative to future customers, a portion of the CAP cost should be
8 recovered through some type of hook-up fee. The amount of the recovery that is recovered through
9 a hook-up fee should be determined by the company's total demand for water relative to its CAP
10 allocation. For example, if a company's total demand is 100 percent of its CAP allocation and its CAP
11 allocation is 100 million gallons per year, then the company should recover 20 percent of its CAP cost
12 from current customers and the remaining 80 percent from hook-up fees. The methodology used for
13 CAP cost recovery in the Vail Water Company Rate Case (Decision No. 62450) is an example of the
14 general policy that Staff advocates.

15 31. Staff requests that the Commission order Staff to develop, through meetings with
16 members of the industry, RUCO, and other interested parties, a detailed statement of policy on CAP
17 cost recovery. The statement should include a description of the methodology used for the recovery
18 methodologies used in the Vail Rate Case, Decision No. 62450.

19 Conclusions

20 32. In conclusion, Staff recommends several changes in and clarifications of Commission
21 policy, several changes to the Commission's rules, and that the Commission pursue several Legislative
22 changes. These recommendations are summarized as follows:

23 Recommendations

- 24 • UC&Ns (new, transfers, and extensions)
- 25 • Acquisition Adjustments and Rate of Return Premiums
- 26 • Set-aside on ratemaking implications of property taxes
- 27 • Electronic Filing and review of filing requirements
- 28 • Phased Rate Increase
- Rates tied to Conditions
- Tiered Rate Structure

22 993

- CAP cost recovery
- Pro forma adjustments

Rulemaking

- Generic Hook Up Fee
- Main Extension Agreements
- Plant Replacement Fund

Legislative Changes

- Incentives for consolidation, e.g. tax breaks
- Replace property taxes with a percentage of revenue tax

33. Staff recommends that the Commission endorse the above policy and Legislative changes. Also, Staff recommends that the Commission open a rulemaking proceeding in order to implement the above changes to the Commission rules.

CONCLUSIONS OF LAW

1. The Commission as the regulatory body with the longest history and the primary responsibility over private water companies should take the lead in seeking a coordinated solution to the problems of small water companies.

2. The Commission arranged for the formation of the Task Force for meetings between representatives of regulatory agencies, the water providers, and water consumers in order to address these issues.

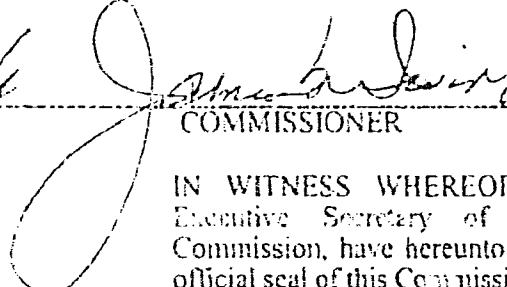
3. The Task Force has issued a report that summarizes the views of its members.

ORDER

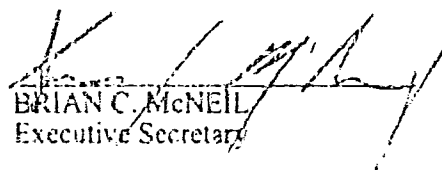
THEREFORE, IT IS ORDERED that the Commission approve Staff's recommendations in the above Findings of Fact.

IT IS FURTHER ORDERED that this decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION


CHAIRMAN
COMMISSIONER
COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL,
Executive Secretary of the Arizona Corporation
Commission, have hereunto, set my hand and caused the
official seal of this Commission to be affixed at the Capitol,
in the City of Phoenix, this 3rd day of November, 2000.


BRIAN C. McNEIL
Executive Secretary

DISSENT: _____

DRS:MJR:llh

ATTACHMENT F

ORIGINAL

RESPONSIBLE RESIDENTIAL
WATER CONSUMER



UOS-00000A-14-0198

2014 JUN 20 P 3:00

SECRET CONTROL May 8, 2014

Arizona Corporation Commission
DOCKETED

JUN 20 2014

Commissioner Susan Bitter Smith
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

DOCKETED BY	me
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In Re: Acquisitions and Consolidations in Arizona's Water & Wastewater Industry

Dear Commissioner Bitter Smith:

Thank you for asking us to begin evaluating the need to consolidate Arizona's water and wastewater industry; the Arizona Residential Utility Consumer Office and Arizonans for Responsible Water Policy have begun a series of discussions on the issue and look forward to working with your office, and the Commission as a whole, on this issue.

The idea of incenting and encouraging consolidation in the Arizona private water and wastewater sector dates back to, at least, the late 1990s. On April 24, 1998 the Corporation Commission voted to establish "The Commission's Water Task Force" with the stated intent of "develop[ing] policies to address a wide variety of problems that private water companies and their customers face."¹ The Task Force conducted numerous meetings and issued a series of recommendations, including:

"Reduce the number of small, non-viable water systems through new rules and procedures."²

The Water Task Force wrote, as justification for its recommendation to begin consolidating the industry:

"Many of Arizona's water companies are quite small; the majority of them have less than \$250,000 in annual revenues... many of these small companies are quite problematic. Most of the "problem" companies that the Commission must deal with are quite small. Because of their small base of customers, even quality managers of small companies may find it difficult to raise sufficient revenues to make needed capital investments."³

The Task Force concluded that "because of economies of scale, larger companies are likely to be more efficient. A larger company can consolidate the administrative aspects of many smaller "systems" thereby significantly reducing the overall cost of service. For these reasons, the Task Force agrees that reducing the number of small non-viable water systems is a desirable goal."⁴

The Water Task Force's report and recommendations were never acted upon by the Commission.

¹ Interim Report of the Arizona Corporation Commission's Water Task Force, October 28, 1999, Page 3 [Docket No. W-00000C-98-0153]

² Ibid, Page 3

³ Ibid, Page 4

⁴ Ibid, Page 4

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

A decade later, in 2010, the Commission directed Commission Staff to open a "generic investigation which looks at how best to achieve the Commission's objectives with regard to encouraging the acquisition of troubled water companies".⁵ Throughout 2011, the Commission hosted water workshops that explored the numerous issues facing Arizona's water industry. The 2011 workshop process led to no final report, no final recommendations, and no final decision by the Commission.


Which all begs the question: If, for over a decade, every interested person has concluded that Arizona needs to incent "the acquisition of troubled water companies", why has nothing been implemented?

The answer, we believe, is that no coalition has formed to evaluate, address, and mitigate the real and complex challenges that come with consolidating an industry. Those challenges are complex, and must be understood before one sets out to "find the right path" toward consolidating an industry with over 300 companies scattered throughout Arizona.

We shall endeavor to do so in this paper.



Pat Quinn
Director, Residential Utilities
Consumers Office



Paul Walker
Chairman, Arizonans for Responsible Water

Paul Walker served as advisor to Chairman Marc Spitzer at the ACC; worked on Governor Jane Dee Hull's negotiating and lobbying team during the Indian Gaming Compacts; and was on the staff of U.S. Congressman John J. Rhodes, III. Paul specializes in regulatory analysis, lobbying, and consulting. In addition, Paul was elected to the national board of directors of ConservAmerica - a 6,000 member Republican organization working to improve the environment through market-based policies at the national level. He chairs Arizonans for Responsible Water Policy - a trade group comprised of large water companies advocating for long-term water policy changes; and serves on the Arizona Power Plant and Line Siting Committee, a statutory board comprised of elected and appointed officials that determines the environmental and economic compatibility of power plant and electric transmission line applications. He served as a Captain in the Arizona Army National Guard and completed numerous military schools and courses; and he holds a Masters in Business Administration from Thunderbird - The American Graduate School of International Management.

Pat Quinn spent over 30 years working in the telecommunications industry before retiring as President of Qwest Arizona in 2008; prior to that position he had served as Vice President of Corporate Policy and Law, Director of Regional Regulatory Affairs, and Finance Director. Qwest was the regional operating company formed after the breakup of the AT&T system in 1984 and provided telecommunication services to the vast majority of Arizona residents. Pat is a veteran who served in the U.S. Navy, and has long been involved in a host of Arizona organizations, including: Greater Phoenix Leadership, the Homebuilders Association of Arizona; Arizona Town Hall; Tee AA and Phoenix Community Alliance. He earned his Master of Business Administration and Bachelor's degree in mathematics from the University of South Dakota. He was appointed as Director of the Arizona Residential Utility Consumers Office in January of 2013.

⁵ Decision No. 71878, Finding of Fact 84, Page 84 [Docket No. SW-20445A-09-0077, et.al.]

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

About Responsible Water: Responsible Water is a trade group comprised of Arizona Water Company, Global Water, and Liberty Utilities. Together, our companies own and operate water and wastewater systems that serve over approximately 500,000 people in communities across Arizona.

Responsible Water is committed to working to make Arizona's water future more secure and more sustainable by working cooperatively with Arizona policy leaders to identify and implement new practices and approaches that strengthen the water industry – and thus, Arizona's ability to manage its water resources. By conducting no-cost seminars for small water companies, developing white papers and studies that explore water management and innovative approaches to regulation, and by providing free technical assistance to troubled utilities, Responsible Water is committed to improving the entire water industry so that Arizona can continue to be a growing, vibrant, and sustainable home for generations.

About the Residential Utility Consumer Office ("RUCCO"): RUCCO is a legislatively established governmental agency dedicated to representing the interests of residential utility ratepayers in matters before the Arizona Corporation Commission ("ACC" or "Commission").

Since establishment in 1983, RUCCO has been actively involved in rate-related proceedings involving public service corporations providing electric, gas, telecommunications, water and waste water services. As a matter of policy, RUCCO always intervenes and participates in rate cases involving Arizona's largest utilities. Intervention in the cases of smaller companies is decided on a case-by-case basis, with particular attention to the size of the increase sought, the rate history of the utility, and the availability of resources at RUCCO. In addition to RUCCO staff, consultants may assist in analyzing utilities' requests for changes in rates and preparing testimony.

In addition to specific rate proceedings, RUCCO is also heavily involved in high level policy decisions made at the ACC. RUCCO approaches topics such as industry regulation, renewable energy, and cost recovery mechanisms with a balanced view that weighs near terms considerations and long-term outcomes. RUCCO prides itself on being a thoughtful stakeholder that can guide the development of smart policies in a way that maximizes benefits to residential ratepayers and the utility system as a whole.

Definitions.

Acquisition Adjustment: An increase to utility rate base which reflects the cost of the purchase of the utility or the asset.

Regional Consolidation: The ability for the acquiring company to consolidate companies into regional or utility groups for purposes of having common rates, operations and management.

Integrated Consolidation: The ability for the acquiring company to consolidate all of their companies into a parent company with common rates, operations and management.

ROE Premium: An increase to the allowed return on equity as an incentive for certain investments. The theory is to provide a return *above the market level* in order to attract investment.

$$\text{AUTHORIZED ROE} + \text{ROE PREMIUM} = \text{COST OF EQUITY}$$

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

The Challenges of Consolidating an Industry

Pat Quinn, BS, MS, Mathematics

Paul Walker, BS, MBA, Business Administration

There are serious economic and regulatory issues that have to be addressed and evaluated before Arizona decides to move forward with consolidating its highly fragmented private water and wastewater industry. We will discuss different aspects of acquisition and consolidation later. The only way to address these issues is to go through them, one by one. This will require the Commission to develop a holistic policy framework that transitions rate setting from a model just based on cost causation to one that includes the enabling of consolidation.

We apologize, in advance, for the fact that many of these issues are only fascinating to people like the authors – we will try our best to avoid making the economic theories too dull or esoteric, but we must emphasize that the reality of Arizona's challenge necessitates a comprehensive understanding of the difficulty of meeting that challenge. The reader should bear in mind that because some of these issues are dull, complex, and esoteric, Arizona has not acted to address this challenge; only with understanding can Arizona solve this issue.

To begin the discussion we need to define the different types of consolidation. Generally we are talking about consolidation as meaning the acquisition of a smaller water or wastewater company by a larger water or wastewater company. This implies the mere acquisition, but not necessarily the incorporation of the smaller company into the large company, i.e., the smaller company still maintains much of its operational autonomy. The other type of consolidation is what we call "integrated consolidation"; with integrated consolidation, the smaller company is fully absorbed into the large company's operation. This can be done at a regional or total company level. This will be discussed more later.

This paper is divided into five sections:

1. The Policy and Factual Landscape of Arizona Water, Page 5
2. A Clear and Compelling Public Interest, Page 14
3. Path to Consolidation, Page 16
4. Consolidation Opportunities, Page 24
5. Summary and Recommendations, Page 25

Additionally, there are four attachments to this paper:

Attachment 1 – "Arizona's Next Century: A Strategic Vision for Water Supply Sustainability", Arizona Department of Water Resources, January 2014, Page 26

Attachment 2 – Rate of Return and Operating Margin Policy, California Public Utility Commission, March 2013, Page 40

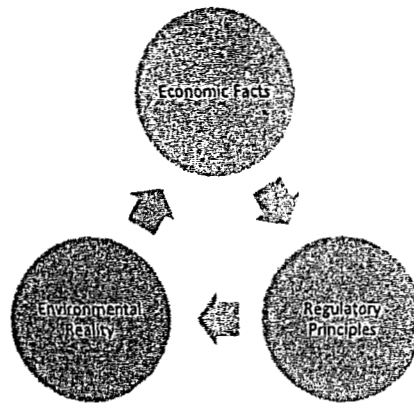
Attachment 3 – Pennsylvania Public Utility Commission Policy on Water Acquisitions, Page 43

Attachment 4 – "Water Utility Risk and Return", California Public Utilities Commission, 1990, Page 49

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

SECTION ONE: THE POLICY AND FACTUAL LANDSCAPE OF ARIZONA WATER

There are three major forces one confronts in the Arizona water industry:



Economic facts must be clearly understood, regulatory principles must be adhered to, and policies must address the environmental reality of Arizona's water supply. The economic fact that Economies of Scale exist provides an opportunity to better control costs and incent investment. This fact is well explained in a 1990 publication of the California Public Utility Commission: "Water Utility Risk and Return."

"[S]mall water companies have special problems created by their lack of economies of scale and inaccessibility to external financing. The number of economic dichotomies between large and small water utilities warrant separate analyses and, ultimately, different ratemaking treatments."⁶

The economic fact that small companies face greater challenges in attracting capital creates a challenge for Arizona's water future; the fact is that most small Arizona water utilities rely on Contributions In Aid of Construction (CIAC) and Advances In Aid to Construction (AIAC) – and wind up with very little rate base, and very few options to access the investment market. As explained in Attachment 4, "Water Utility Risk and Return":

"[T]he stability of the water utility business should provide comfort to creditors and equity investors seeking attractive investment opportunities with relatively low risk. However the small size of water utility offerings, relative to other utilities, tend not to generate interest among investment bankers. Consequently, most water utilities remain unknown except to a subset of the financial community such as insurance companies. Virtually all external financing is accomplished through private placement directly with investors, without use of an underwriter."⁷

The regulatory principles of "Cost Causation, Equity, and Sustainability" can be adhered to in an acquisition and consolidation policy. This will require the Commission to modify the current policy to encourage smart consolidation. Finally, the "Environmental Reality" of Arizona's water situation today, and all water forecasts for Arizona, provide a clear and compelling public interest in strengthening and consolidating this industry. We shall explore each of those issues in this section.

⁶ "Water Utility Risk and Return", California Public Utilities Commission, April 1990, Page 1

⁷ Ibid, Page 3

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Economic Facts

One economic fact directly correlates to the question and benefits of consolidating the Arizona private water and wastewater industry: Economies of Scale. This term is fairly common, but it is important to ensure that it is understood at the outset.

Economies of Scale: Economies of scale mean that a firm's average cost decreases as its output rises.

Example: The fixed costs of owning and operating a small water system include: the costs of the well and the pipes that deliver the water. Once those are in place, the costs are spread over the customer base. If the customer base grows, there are more people paying those fixed costs and they will each pay less.

Example: The costs of running a customer call center include the cost of the building, the telecommunications services, and the employees. Once those are in place, the costs are spread over the customer base. If one company owns and operates numerous utilities, it can use the same call center to support each utility – rather than building and financing a call center for each utility on its own.

Example: A utility requires not just the day-to-day operational staff; it also requires a management team to oversee the accounting, capital improvement plans, financing, environmental compliance and reporting, human resources, and investor relations. However, the management team that provides those services to a utility can provide those services to more than one utility – when it does so, it takes advantage of economies of scale because the incremental costs of providing that management to a second, third, or tenth utility are less than the costs of having each of those other utilities having its own, independent management team.

Thus, economies of scale means that "large water utilities are able to provide professional management and lower cost service because they spread the fixed costs of operations over more customers."⁸ However, as we move forward in this paper the reader should bear in mind that the looming investments in water infrastructure, sustainability, and increased water supplies will exert dramatic upward pressure on rates. Thus, while economies of scale provide downward pressure on rates, Arizona's future is one of increasing investments, increasing costs, and thus, increasing rates for water customers.

Small Firm Capital Attraction Challenges: Smaller entities have fewer opportunities to access the investment market.

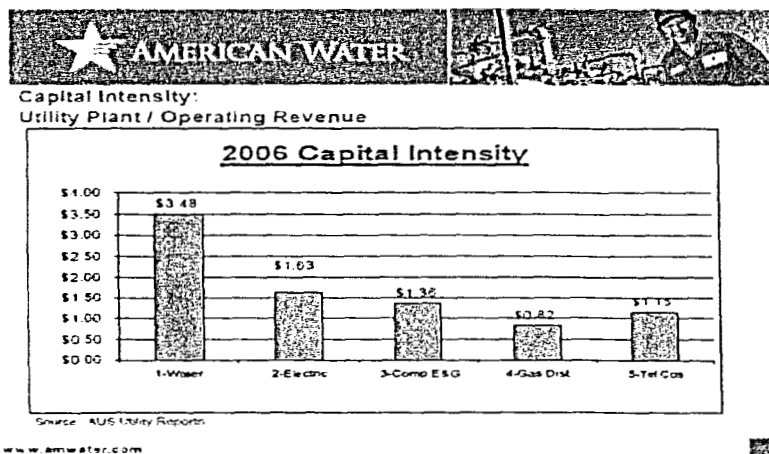
As CPUC explained, small firms "tend not to generate interest among investment bankers" therefore the majority of their financing comes from the owners and from any developers who build in the service area (through CIAC and AIAC.) The resultant capital structure from such an approach winds up producing very

⁸ Ibid, Page 19

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little rate base – it is startlingly common in Arizona to find small water utilities with little to no rate base. That we have become accustomed to it is more alarming than the very fact itself. Arizona needs to realize, literally right away, that: “The financial structure of the company to a great extent determines financial risk.”⁹

Many companies with little to no rate base face extreme financial risk – they have no rate base to produce a return on equity, and are simply operating margin entities in a business that faces significant environmental challenges and very high capital intensity. Capital intensity is the measure of: How much investment in plant is required to produce \$1 in additional operating revenue.



To summarize then, economies of scale can reduce the average cost per customer; but many small water utilities in Arizona have very challenging financial profiles that make them hard to invest in, and make it hard for their current owners to attract needed investment. Because of the latter challenge, owners rely on developers to fund their utility needs – thus further weakening their financial structure:

“Advances and contributions spread out the utility’s funding requirements for growth and development in the service territory. These sources of funds are not included in utility rate of return calculations because these sources of capital are not provided by company investors. Nonetheless, operational risks increase as the percentage of contributions increase for the utility. For example, assuming a 10% return on rate base, a utility with \$100,000 in plant, of which 40% is contributed, can only generate a return on investment of \$6,000. If the utility had used debt and equity capital, it would be able to earn \$10,000. The operational risk is highlighted when revenues change due to voluntary conservation and/or mandatory rationing.”¹⁰

In fact, in many cases in Arizona the CIAC (or the AIAC that reverts to CIAC due to lack of growth) becomes so large that it subsumes the owners’ investment. Building on the CPUC example above, if the utility had received \$40,000 in Advances, but the growth didn’t occur as expected and thus only \$10,000 of the AIAC was repaid, \$30,000 in “CIAC” would be assigned to the rate base – cutting the rate base from \$60,000 in the CPUC example, to \$30,000; and cutting the return from \$6,000 to \$3,000. This example is not hypothetical, in fact it is commonplace among small Arizona water utilities – thus further worsening their capital structure, increasing their risk, and making their acquisition more difficult for potential buyers.

⁹ Ibid, Page 2

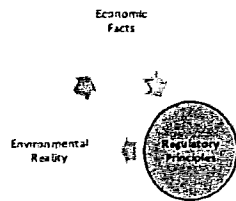
¹⁰ Ibid, Page 13

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Regulatory Principles

There are three key regulatory principles that must be strictly adhered to should Arizona move forward with a policy and incentives to encourage consolidation of the Arizona water and wastewater industry: Cost

Causation, the Equity Principle, and Sustainability. Cost Causation and the Equity Principle will be the most complex issues to explain to customers. This is why criteria for when and how to consolidate must be developed.



The reality is this: Consolidations and Acquisitions come with costs – and those costs must be recovered in a fair and manageable manner. However, there will be some cost savings that come from economies of scale that may reduce or mitigate these increased costs. Investors and customers are, quite literally, in the same position here: Both can benefit from a stronger, more consolidated industry, the key is to understand how to balance the costs.

Principle 1: Cost Causation – the customer who causes a cost should pay the cost.

Equality vs. Efficiency: Cost causation involves one of the most complex issues in economics, what Arthur Okun called “the big tradeoff”. Economic equality means that no one gets an unfair advantage over another – which is obviously subjective because everyone has an opinion on what constitutes “fair and unfair.” Economic efficiency means that correct pricing signals are sent, and those incentives correlate to desired outcomes.

Principle 2: Equity Principle – no customer should be forced to pay more than what is reasonable.

Rate Design: Cost allocation is the purpose of rate design – it is the process of determining how many dollars to collect from various customer classes for various utility services.

Just and Reasonable Rates: The rates set by the Commission must not be unduly discriminatory between customers or services. “Unduly discriminatory” means that the discrimination in pricing or incentives is tied to and supports some public interest, e.g., tiered water rates charge exorbitantly high rates for high use of water – much more than the incremental cost of providing high amounts of water – but those high rates are justified because they support the public interest of conserving water.

Subsidies: Generally, Commissions avoid providing subsidies (“subsidies” are defined here as: charging less than the incremental cost of the service to one group of customers, while charging more than the stand alone cost to another group of customers.)

Efficiency: Commission rates and incentives should give correct signals to customers and investors (“correct signals” are defined here as: promoting the efficient use of resources, and allowing customers and investors to manage and plan their budgets.)

Principle 3: Sustainability – the utility must receive enough money to stay in business and continue providing safe, adequate, and reliable service.

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Sufficiency: Utility rates and incentives should be sufficient to allow the utility to collect its legitimate costs. At the same time, decreases or increases in risk should be recognized and applied in a symmetric manner to the company's authorized rate of return in order to establish fair compensation to shareholders.

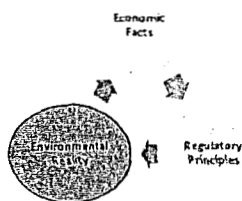
Transparency: Commission rates and incentives should be understandable to customers and the utility.

Stability: Commission rates and incentives should avoid rate shock to customers, and should promote revenue stability to the utility. Commission rates and decisions must provide price and investment signals and the Commission must recognize that those signals will affect behavior, but it may take some time to do so.

If done correctly, establishing a consolidation enabling framework for Arizona water companies will integrate these three principles in a more holistic way. First, the true cost of one's water system may be hidden from customers if needed upgrades are not made or systems are neglected. Second, equity is a principle that is dependent on one's time horizon. In the medium to long run, the consolidation of two water systems may bring resiliencies and efficiencies that overcome short run inequities. Third, sustainability comes when the true long run costs of operating a successful water system are recovered and allocated within a system that is resilient and efficient. Smart consolidation between companies should leverage all three of these principles in a way that delivers long-term net benefits to all ratepayers involved.

Environmental Reality

All of the economic facts and regulatory principles must, in the end, deal with and address reality. And Arizona's water reality is complicated. Arizona water leaders have worked hard on water management since the 1922 Colorado River Compact. The Central Arizona Project, the 1980 Groundwater Management Act, the Central Arizona Groundwater Replenishment District, Commission-sanctioned Tiered Rates, Water Banking, and more environmentally sound development have created a vast network of infrastructure and programs to better manage Arizona's water supplies; but ongoing drought combined with population growth will continue to demand larger and larger investments and increasingly sophisticated water monitoring and management.

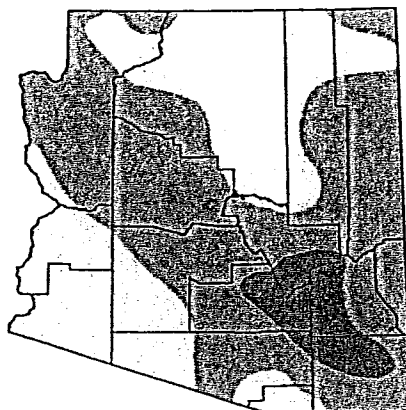


Arizona has relied for decades on affordable CAP water – which provides water for agriculture and communities, and the Colorado River dams which provide affordable hydropower that both offsets CAP costs, and provides reliable and affordable power to rural Arizona. But Arizona remains mired in drought, and the drought goes beyond the Colorado River – it covers nearly all of Arizona and droughts are very hard on small water companies – pumping costs increase, CAGR costs increase, development gets more costly and complex. Drought can be managed – but at a high cost financially, managerially, and technically.

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Arizona Remains in a statewide drought

U.S. Drought Monitor Arizona



April 22, 2014
(Released Thursday, Apr. 24, 2014)
Valid 8 a.m. EDT

Drought Conditions (Percent Area)						
	None	D0-D1	D1-D2	D2-D3	D3+	Total
Current	0.00	100.00	98.17	91.20	7.31	0.00
Last Week (4/15/14)	0.00	100.00	98.98	87.06	5.18	0.00
3 Months Ago (1/22/14)	18.28	83.82	67.79	34.84	0.00	0.00
Start of Calendar Year (1/1/14)	28.72	79.28	63.88	14.73	0.00	0.00
Start of Water Year (10/1/13)	14.83	86.17	61.91	28.28	0.00	0.00
One Year Ago (4/22/13)	2.62	97.38	83.82	57.68	18.80	0.00

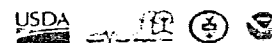
Legend:

D0: Extremely Dry D3: Extreme Drought
D1: Moderate Drought D2: Severe Drought

The Drought Monitor reflects an approximate condition.

Local conditions may vary. See accompanying text summary for detailed statements.

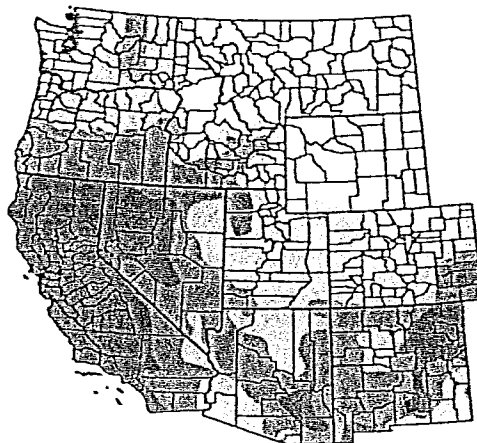
Author:
Richard Heim
NCEM/NOAA



<http://droughtmonitor.unl.edu/>

The drought affects not only Arizona – in fact, the entire west is gripped in a historic drought. Today, four of the seven Colorado River states are covered, 100%, in drought conditions, and Utah is almost entirely in drought. The Colorado River is in a historic drought and curtailment of the water deliveries that Arizona relies on for CAP, agriculture, and groundwater recharge seems likely to occur sooner, rather than later.

U.S. Drought Monitor West



April 22, 2014
(Released Thursday, Apr. 24, 2014)
Valid 8 a.m. EDT

Drought Conditions (Percent Area)						
	None	D0-D1	D1-D2	D2-D3	D3+	Total
Current	30.11	69.89	91.81	48.28	17.33	4.81
Last Week (4/15/14)	30.38	69.82	82.64	43.84	16.06	4.06
3 Months Ago (1/22/14)	18.74	81.26	60.81	36.99	13.78	0.43
Start of Calendar Year (1/1/14)	22.32	77.68	61.44	31.91	7.93	0.83
Start of Water Year (10/1/13)	25.28	74.72	58.94	34.15	6.87	0.43
One Year Ago (4/22/13)	22.38	79.72	64.00	43.41	16.40	1.87

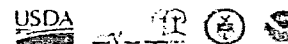
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D1: Moderate Drought D2: Severe Drought

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Local conditions may vary. See accompanying text summary for detailed statements.

Author:
Richard Heim
NCEM/NOAA



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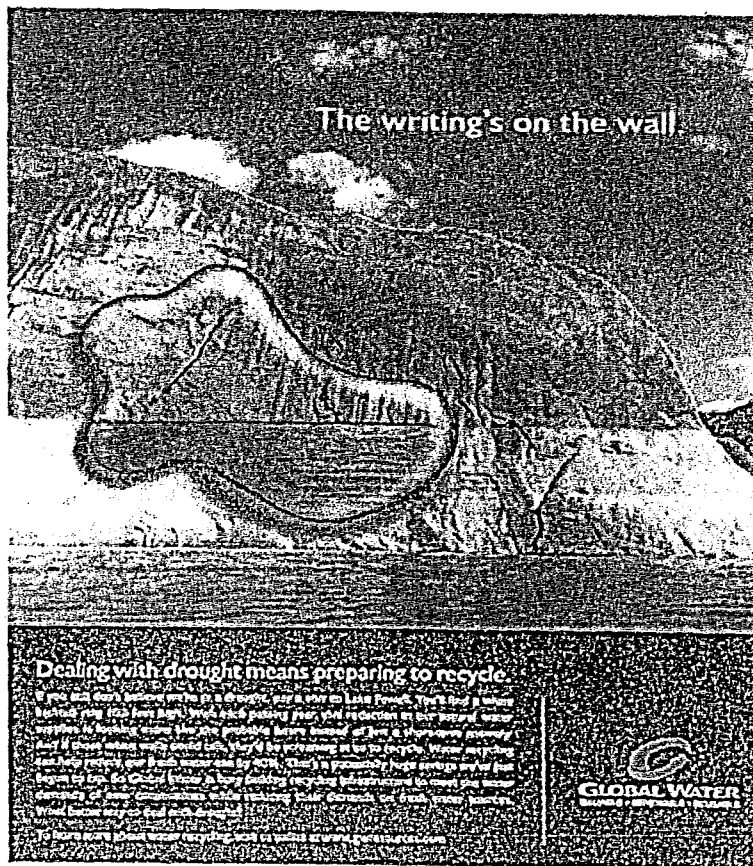
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Most experts agree that the [Colorado River] basin will get even drier

"Already, the drought is upending many of the assumptions on which water barons relied when they tamed the Colorado in the 1990s... Lake Mead currently stands about 1,106 feet above sea level, and is expected to drop 20 feet in 2014. A continued decline would introduce a new set of problems: At 1,075 feet, rationing begins; at 1,050 feet, a more drastic rationing regime kicks in... Should Mead continue to fall, Arizona would lose more than half of its Colorado River water... That would have a cascading effect. The Central Arizona Project would lose revenue it gets from selling water, which would raise the price of water to remaining customers, leading farmers to return to pumping groundwater for irrigation – exactly what the Central Arizona Project was supposed to prevent."¹¹

The Colorado River drought also affects the Glen Canyon and Hoover Dams

"At Glen Canyon Dam, the Bureau of Reclamation plans to reduce releases by 750,000 acre-feet for the coming year, a historic low. The iconic Hoover Dam is experiencing a 14-year drought, the worst in the last 100 years... For Western [Area Power Administration], insufficient water results in not having sufficient hydropower to meet its contractual obligations. Under many of [Western's] contracts, [it] must purchase more expensive power on the market to meet [its] obligations."¹²



¹¹ The New York Times, "Colorado River Drought Forces a Painful Reckoning for States", January 5, 2014

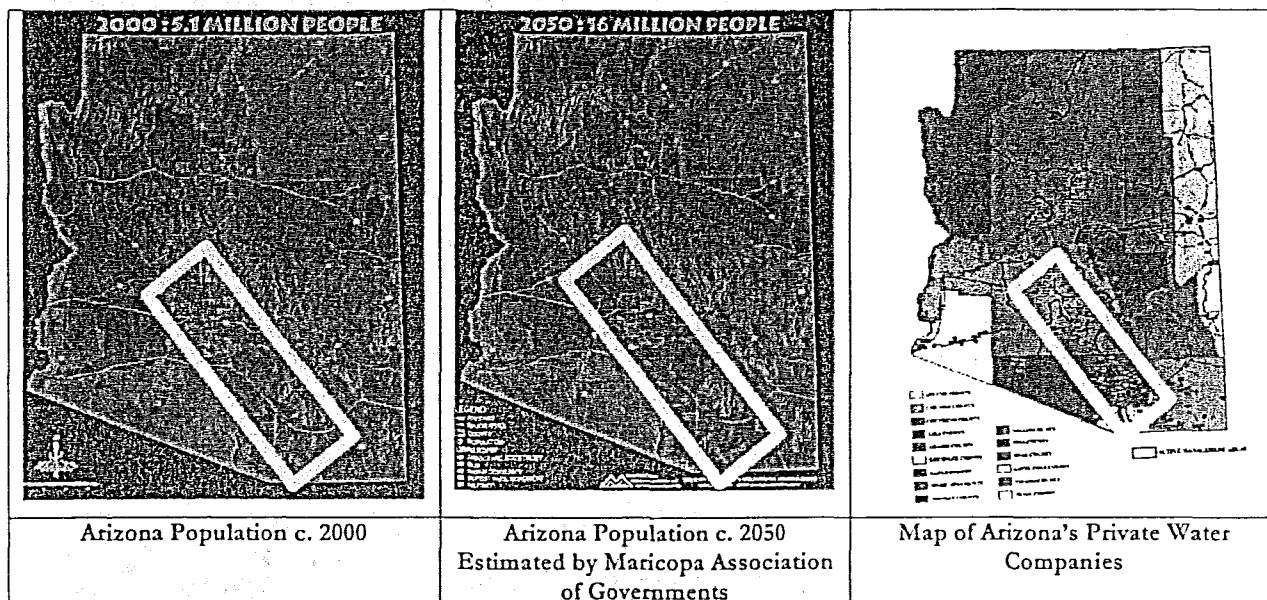
¹² EnergyBiz Magazine, "Powering a New Frontier", January/February 2014

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Arizona's "growth corridor" has an unmistakable correlation to Arizona's private water industry

The best estimates of Arizona's likely future growth are unmistakably correlated to the areas served by Arizona's private water industry – the reason is simple: Most private water companies exist outside of town and city limits, because towns and cities usually have their own, municipal water system. Many people choose to live outside of towns and cities, when growth moves beyond an existing town or city limit, it invariably runs into areas served by private water companies.

Arizona's Growth Corridor and Arizona's Private Water Utilities



The Arizona Department of Water Resources (ADWR) issued a milestone assessment of Arizona's water situation in January of 2014, "Arizona's Next Century: A Strategic Vision for Water Supply Sustainability." We are pleased that ADWR's Director, Michael Lacey, asked us to attach Arizona's Next Century to this white paper – Attachment 1 is that report's Executive Summary. The entire report, 60.58 MB, can be found on ADWR's website at this URL:

http://www.azwater.gov/AzDWR/Arizonas_Strategic_Vision/documents/ArizonaStrategicVisionforWaterResourcesSustainability.pdf

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In Arizona's Next Century, ADWR highlights several "strategic priorities" for Arizona:

1. Resolution of Indian and Non-Indian Water Rights Claims
2. Continued Commitment to Conservation and Expand Reuse of Reclaimed Water
3. Expanded Monitoring and Reporting of Water Use
4. Identifying the Role of In-State Water Transfers
5. Supply Importation - Desalination
6. Develop Financing Mechanism to Support Water Supply Resiliency

Clearly, a consolidated, strong water industry in Arizona would be able to address Points 2, 3, and 6. And a consolidated, strong water industry could play a key role in financing and supporting Points 4 and 5.

Because of Arizona's water challenge, ADWR states that: "The current challenge facing Arizona is that although the State has an existing solid water management foundation, water demands driven by future economic development are anticipated to outstrip existing supplies. Additionally, the availability of surface water supplies have been reduced in recent years as drought conditions have been experienced locally and throughout the Colorado River Basin."

Summary

The growing, and worsening, drought in the U.S. west will require vast investments in Arizona's water infrastructure. It has been known for some time that the 1922 Colorado River Compact allocated the River's water supplies based on abnormally high River flows - there is not 15 million acre-feet per year in that River, it's more like 13 million but even that flow is highly volatile as the West is now, painfully, realizing.

ADWR's strategic priorities for the 21st Century make it very clear that Arizona is facing a high-cost future: Desalination will be a multi-billion dollar effort, and Arizona's private water industry will need to be large enough and strong enough to contribute hundreds of millions of dollars to that 21st Century effort.

ADWR's final strategic priority, "develop funding mechanisms to support water supply resiliency" is not only essential to desalination but also to ADWR's other strategic priorities. Expanding the use of reclaimed water, increasing water monitoring and conservation, and in-state water transfers all will come at great cost. Thus it is imperative for Arizona and all Arizona residents, that the Commission strengthen and consolidate the private water sector to meet the 21st Century water challenges we face as a state.

While economies of scale will provide downward pressure on prices and rates, it must be clearly understood that consolidating and strengthening Arizona's water infrastructure will be a massively expensive effort that will take decades. So, economies of scale and consolidation will not result in decreasing rates in the near term - they will only provide downward pressure as Arizona deals with, and invests in, its 21st Century water challenge. Drought, volatile and diminished Colorado River supplies, desalination, reclaimed water and increased monitoring and conservation efforts are each costly, and all necessary and prudent to secure Arizona's water future.

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SECTION TWO: A CLEAR AND COMPELLING PUBLIC INTEREST

Because Arizona faces significant, increasing, and costly environmental challenges due to water scarcity, it must evaluate the ability of the private water and wastewater industry to meet those challenges over the long-term and to do so in an affordable way for utility customers. Arizona's private water industry lies in the path of Arizona's future growth, therefore the Commission must play an active role in planning for Arizona's water future.

Economies of scale and future water scarcity and increasingly strained sources are critical factors that support the consolidation of the highly fragmented Arizona water industry. There are over 300 firms providing private water and wastewater services in Arizona – and as the environmental challenges and costs mount, more and more of those firms will become non-viable and more and more will descend into economic crisis. The Commission has, since 1998, been concerned with the viability of small water systems; and with the drought and the long-term change in Colorado River supplies, the time has come to address consolidation of the industry.

At the outset, it is imperative to recognize that not all small systems have to be consolidated – the Commission's interest is simply in ensuring that each water and wastewater system has adequate financial, managerial, and technical ability to provide safe, adequate, and reliable service both today, and into the future. To that end, the Commission should amend its Annual Report rule to also require water and wastewater systems to include the following data and any other information the Commission deems necessary:

- Regulatory compliance currently (ADWR, ADEQ, ACC, ADOR, and County and City compliance).
- Regulatory issues the company foresees in the next five years.
- Basic Financial Ratios: DSC and TIER, which measure liquidity and viability.
- One year Capital Improvement Plans that estimate:
 - o the capital improvements (for repair and replacement of existing infrastructure), and
 - o development that the utility believes will occur in that timeframe (with the utility's plan to cover those costs through MXAs, HUFs, and/or debt and equity financing.)

The Commission needs to also establish and levee sanctions and fines for willful failure to comply with regulatory requirements and standards. This will help encourage companies to establish adequate financial, managerial, and technical ability to meet the challenges of today and tomorrow.

However, simply relying on the "stick" of regulatory oversight is not likely to be sufficient. The Commission should focus on improving the regulatory and financial climate for small water companies to ensure they are filing frequent rate cases, building their financial strength, and preparing for a more challenging water future.

Responsible Water has launched efforts to aid small, troubled water companies to assist them with regulatory compliance and financial challenges. Additionally, Responsible Water is launching a free water seminar series to provide small water companies with detailed briefings on regulatory issues, compliance, and financing. The Commission and the Department of Water Resources are also participating in the seminar series – thus tying outreach and information to the "carrot" and "stick" and increasing the ability of small water companies to meet Arizona's 21st Century water challenge.

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The public interest is well outlined in a memorandum provided to us from Steve Olea, Director of the Commission's Utility Division:

"Unfortunately, it is not uncommon for small, troubled water systems to develop compliance issues with federal, state, or local requirements. Very often, these troubled systems lack the financial capacity or the technical expertise to correct these issues. When such a small, troubled system is acquired by a large, well operated, and well financed water system, the potential for significant benefits to ratepayers is obvious. This is the type of consolidation that should be encouraged, and the Commission's acquisition policy should be tailored to these types of situations."

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SECTION THREE: PATH TO CONSOLIDATION

Consolidation is often used to define many different types of outcomes. To begin the discussion we need to define the different progressions of consolidation. The first and most typical consolidation is a simple acquisition - where a larger company simply acquires a smaller company. This may bring some economies of scale to the acquired company.¹³ However, for the most part the smaller company is still largely autonomous with its own rates and operations.

The next progression of consolidation occurs when the smaller acquired company is merged with other regional holdings of the large company. This "regional consolidation" can result in more economies of scale. This is accomplished through geographically combined rates, operations and management. The final progression is when the larger company is allowed to merge all of their holdings into one company and establish rates that apply to all their customers. This "integrated consolidation" allows for the greatest economies of scale (and scope.) To allow for this consolidation to progress in the public interest of ratepayers, a strong set of criteria needs to be developed to intelligently transition from small acquisitions to regional consolidation, and then, if justified, full integrated consolidation.

The process leading to full scale consolidation is a long one and it fundamentally starts with the basic acquisition. Therefore, the key to realizing the end goal of large scale integrated consolidation is to first encourage acquisitions.

There are four main enabling policies:

1. Rate base acquisition adjustments
2. Allowance of regional consolidations
3. Rate of return on equity (ROE) premiums
4. Cash flow/operating margin inducements

The first two policies are specific to the situation and company - therefore limiting the scope and the ability to streamline their application. However, ROE premiums and cash flow inducements can be setup for statewide application through sliding scale mechanisms and/or qualifying criteria such as class of company being taken over, water loss thresholds, certain financial metrics, etc. The ability to possess a regulatory toolkit that can be customized when need be or streamlined when the situation calls for it will enable more acquisitions and thus deliver integrated consolidation sooner.

Each policy tool will now be described in detail:

Acquisition Adjustment - Strengthening Viability, Incenting Acquisitions

An "Acquisition Adjustment" is a decision by a public utility commission to include some or all of the acquisition cost of a company into the company's rate base. Most small water companies have very small (and in many cases, non-existent) rate bases.

This occurs because of several factors: First, oftentimes the original plant has simply been fully depreciated over time; Other times, these companies don't have the financial resources to build their infrastructure so

¹³ And perhaps also economies of scope if the acquirer is, for example, an integrated water and wastewater company and it acquires a strictly water company.

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they rely on developers to build and finance the utility plant – meaning it becomes CIAC and is excluded from rate base; Finally, very frequently the company does invest in plant and repairs, but the developer CIAC is so large that it simply negates the owners' investment. In each of those cases, the company's book value is virtually nothing; but its service area and operating revenues have financial values that support an acquisition price well above book value.

However, the buyer of the company has no way to recover the acquisition price if it is not included in rate base. Sometimes, that sunk cost is adequately compensated by the opportunity to grow the acquired entity or simply through the revenue stream from the acquired company. An example of that sort of acquisition is EPCOR's acquisition of Chaparral Water in Fountain Hills. EPCOR paid an acquisition cost approximately 30% higher than Chaparral's book value, but the economics didn't necessitate an acquisition adjustment.

That example comes with a huge caveat – Chaparral Water was, by all accounts, a successful, capable, well-managed company with more than adequate financial, managerial, and technical ability. What Acquisition Adjustments and a Consolidation policy must address is companies that aren't viable, or are in danger of falling into crisis because they lack the financial, managerial, and technical ability to deal with current and looming issues (such as, e.g., Arizona's drought.)

There are two sources the Commission and the Courts must consider when determining the justness of an acquisition adjustment – Judge Learned Hand, one of America's greatest jurists, in the 1943 *Niagara Falls Power Co.* decision, and Professor James Bonbright, who wrote "Principles of Public Utility Rates".

Judge Learned Hand in *Niagara Falls Power Co. v. Federal Power Commission*¹⁴

If the rate base were to be set at the price paid by the new purchaser, then "the [company] who does not sell is confined for [its rate] base to [its] original cost; [the company] who sells can assure the buyer that [it] may use as a base whatever [the buyer] pays in good faith. If the [seller] can persuade the buyer to pay more than the original cost the difference becomes a part of the [rate] base and the public must pay rates computed upon the excess. Surely this is a most undesirable conclusion."

- *Niagara Falls Power Co. v. Federal Power Commission*, 137 F (2d) 787, 793 (1943)

Thus, Judge Learned Hand's view is: If the Commission simply allows any cost above original cost to be included in rate base, the seller will "assure the buyer that [it] may use as a base whatever [the buyer] pays in good faith." This will increase sales, but it will do so by changing the economics so that buyers become more indifferent to the purchase price, and sellers realize that the regulatory price constraint no longer exerts a downward force on the price they ask.

Professor Bonbright, in "Principles of Public Utility Rates"

"[I]nvestors are not compensated for buying utility enterprises from their previous owners... Instead, they are compensated for devoting capital to the public service."

- Chapter XII, "Original Cost versus Subsequent Acquisition Cost" section.

¹⁴ As cited in "Principles of Public Utility Rates" (Chapter XII, "Original Cost versus Subsequent Acquisition Cost" section.)

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"The foregoing conclusion is subject to revision if the transfer of the properties to their present corporate owner was an essential, or at least a desirable, part of a program of integration, justified in the public interest for the purpose of securing operating efficiencies that would offset any unavoidable excess in acquisition costs over original costs. In such a situation... a claim by the [purchasing] company that its purchase of the acquired properties was, in effect, a devotion of capital to the public service, cannot be dismissed as without merit."

- *Ibid*

[In such a situation, the purchasing] "company may properly receive an opportunity to prove its claims, although difficulties of proof are serious. Proof should be more readily adduced with respect to mergers and acquisitions, the terms of which have first been cleared with the regulating commission after a full public hearing and investigation."

- *Ibid*

Thus, Bonbright's view is the acquisition cost is not a *per se* contribution to the public service warranting a return - unless:

- 1) The acquisition was justified in the public interest, and
- 2) The acquisition costs allowed were set after a full public hearing and investigation.

Therefore the Commission should not do what Judge Hand warned about, it should not "simply allow any cost above original cost to be included in rate base". It should follow Professor Bonbright's pathway to consider whether "the transfer of the properties to their present corporate owner was an essential, or at least a desirable, part of a program of integration, justified in the public interest" by evaluating such claims through the hearing process.

This view is also reflected in Mr. Olea's recent memorandum on acquisitions:

"The Commission should not provide ratemaking incentives for consolidation simply for the sake of consolidation. In order for an incentive to be appropriate, the water company seeking the incentive must show that the consolidation will provide clear and tangible benefits to ratepayers in an amount that is at least equal to the proposed incentive. Furthermore, an incentive should not be awarded unless the purchase price is the product of an arm's length negotiation. The fact that a consolidation may provide benefits to the respective systems' shareholders/owners is not a factor that should support award of an incentive." [Emphasis added]

While we wholeheartedly agree with nearly everything Mr. Olea states in that paragraph, we caution the Commission on the highlighted text: Quantifying the benefits of consolidation to determine if they are "at least equal to the proposed incentive" is not possible, and with all due respect to our friend and colleague, that effort does not address the real reasons for consolidation.

The U.S. Drought Monitor shows the severity of the West's and Arizona's drought. It is now known, for certain, that the Colorado River was over-allocated and that the River is more volatile than anyone anticipated. Arizona has been in persistent drought conditions for over a decade and it appears that rain and snowfall are now more volatile and will remain so, whatever the cause.

ADWR is correct in stating the need for significant increases in water monitoring, conservation, reclaimed water reuse, and the need to begin laying the groundwork for desalination. Those are vastly expensive

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individual elements – and yet, Arizona needs to take all those steps and begin doing so today, Arizona is at the end of the “cheap water” era and at the forefront of a world in which water is more scarce, more valuable, and more expensive.

Consolidation and economies of scale will not continue the era of cheap water – they will simply smooth the path to the future value and cost of water in Arizona.

Consolidations will be very unlikely to “pencil out” in the near term – because the cheapest course of action in the near term is always to do nothing. But over the longer term, within the next decade and certainly beyond that water is going to become expensive and will require highly sophisticated, financially strong water management companies. That is the true benefit from consolidation – and that should be the test the Commission applies when considering consolidations and acquisition premiums.

The Commission should evaluate applications for acquisition adjustments on a case-by-case basis, but it would be well served by establishing that there is a compelling public interest in seeing the water industry strengthened through a program of acquisitions that lead to consolidation.

The Commission should adopt an acquisition policy similar to those of Pennsylvania's Public Utility Commission.¹⁵ Pennsylvania's policy lays out a few major points:

- The intent of the policy is to increase mergers and acquisitions to achieve regionalization.
- Each acquisition must serve the public interest.
- Acquired systems are below a certain size (3,300 connections), and the acquired systems was:
 - Not viable;
 - In violation of statutory or regulatory standards concerning the safety, adequacy, efficiency or reasonableness of service and facilities;
 - Failing to comply, within a reasonable period of time, with any order of the Department of Environmental Protection or the Commission.

Here we must note that the above criteria from Pennsylvania should *not* be construed as *requiring* each of those elements. To do so would be to instantly create an incredibly perverse and dangerous incentive for small systems to ignore statutes, regulations and orders. The Pennsylvania model simply lays out three criteria, any one of which (combined with the prerequisite limit on system size) can be evidence of “public interest” in the acquisition and thus the awarding of an acquisition adjustment.

Pennsylvania also allows an ROE premium to be combined with the acquisition to address and incent “associated improvement costs.” Meaning that, if the acquired utility has significant investment needs, the Pennsylvania PUC can provide an ROE premium to make the acquisition of the troubled system even more attractive.

In an interview in Arizona Regulatory Reports, Pennsylvania PUC Chairman Robert Powelson explained that Pennsylvania's “policy of encouraging regionalization and consolidation via inter-agency cooperation and acquisition incentives has resulted in improved water quality and service reliability for many customers throughout our state”. Such a result is by itself meaningful, but Mr. Powelson also explained that “customers

¹⁵ Attachment 3

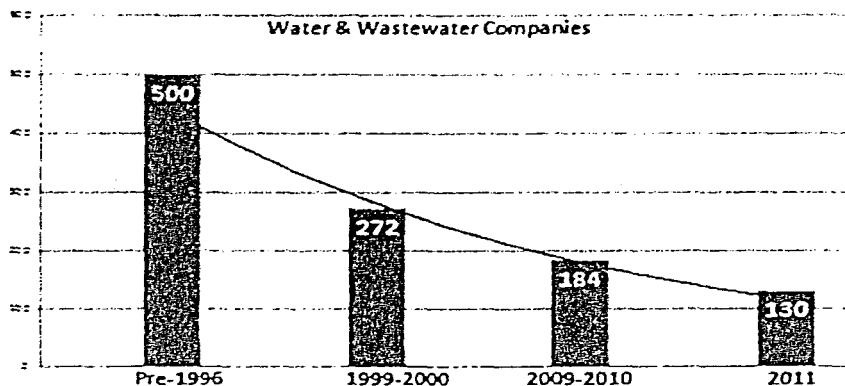
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who were previously faced with chronically non-compliant service from small, marginally viable providers” were now seeing improved quality, reliability, and safety in their utility service.¹⁶

That same article provided the following graph which demonstrates exactly how effective the Pennsylvania policy has been in incensing consolidation:

Pennsylvania Policy Statement on Acquisition Incentives

52 Penn. Admin. Code §§ 69.711, 69.721



Regional consolidations – authorizing the unification of geographically close systems

It is quite possible that a company could acquire a smaller company that is situated in close proximity to some other companies they own. These companies could for various reasons be consolidated into a regional entity with common rates, operations and management. This could occur if there were common facilities, shared water supply or potential economies of scale. For example, maybe the newly acquired company has a well that can pump more water than is needed and the neighboring company faced a shortage of water. It may be more cost effective to run pipe from the producing well to the other company's system than to drill new wells. There are many other examples of why regional consolidation makes good business sense, most of which are so obvious that they needn't be repeated here.

Rate of return on equity (ROE) premiums

To narrowly tailor the ratemaking incentive to the behavior that the Commission wants to encourage, the Commission could consider specific risk adjustments to the acquiring company's return on equity ("ROE"). The risk adjustment to the ROE could be limited to the system improvements (once completed) that are needed either to bring the acquired water system into compliance or to address quality of service issues, similar to Pennsylvania's "associated improvement costs" reason for an enhanced ROE.

¹⁶ Arizona Regulatory Reports, Issue 11-4, August 2011

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Focusing on the ROE in this manner more narrowly tailors the ratemaking incentive to the behavior that the Commission would like to promote: the acquisition of smaller, troubled water companies by larger, well managed companies and the subsequent completion of system improvements.

Under this approach, the purchase price in the acquisition could be irrelevant; i.e., the ROE premium on its own could encourage and incent the acquisition without the need for an acquisition adjustment to rate base. The buyer would retain the incentive to negotiate the best possible purchase price (because he would know that the Commission would not increase the rate base by the acquisition premium), and the seller would have less reason to expect that an inflated purchase price could be simply passed on to ratepayers. At the same time, the buyer would have an incentive to purchase a troubled water company because he would know that the subsequent prudent investments that are necessary to improve the acquired system could be eligible for a higher ROE.

The precise adjustment to ROE would need to be determined in a rate case that is filed after the system improvements have been made. For example, if the ROE analysis in a rate case resulted in an ROE of 9 percent, and if the risk adjustment were 100 basis points, the ROE for the system improvements would be 10 percent, and the ROE for the remainder of the system would be 9 percent. The Commission may also want to consider whether the system improvements would continue to be eligible for an adjusted ROE in subsequent cases.

It is important to recognize that both of the ratemaking mechanisms discussed herein (the acquisition premium and the ROE adjustment) will result in higher rates.

Cash flow/operating margin inducements

The water and wastewater industry can only be consolidated by a) making companies viable, and b) incenting the acquisition of non-viable or challenged utilities. This view was precisely espoused in the Commission's 1999 Water Task Force report, and it was repeatedly stated in the Commission's 2011 Water Workshops. Very often in the review of acquisition policies the former point is forgotten, i.e. that strengthening viability is an essential tool in consolidating the industry.

"[S]mall water utilities are clearly more risky than large water utilities and theory would support the notion that the required return on investment should be higher for small water than for large water companies."¹⁷

By strengthening the viability of water and wastewater utilities, the companies become economically attractive without the need for an acquisition adjustment. Encouraging friendly mergers and acquisitions by ensuring financial viability is likely to be a lower cost path toward consolidating the industry and achieving economies of scope and scale.

The Commission's recent decision to consider adjusting utility classification revenue thresholds to account for inflation is likely to be useful in this regard, because it is likely to make rate case filings less costly and simpler for small and medium-sized water and wastewater utilities. A second step the Commission should consider is increasing the operating margin that is provided to utilities that lack rate base, as is the case for most small systems. A range should be established by the Commission after careful consideration. Criteria

¹⁷ "Water Utility Risk and Return", Page 20

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should be developed to allow the Commission to have the flexibility to set the percentage on a case by case basis. Currently, the Commission allows operating margins from 5 to 20% (although the authors' experience is that the margin is usually around 10%). By way of comparison, in California, the smallest water utilities there – the Class C and D companies – receive operating margins of 20.73% and 22.08% respectively.¹⁸

The California position is supported by its determination that “a small water utility's earned rate of return is significantly greater than that of a large water utility. Small water utilities also face greater operating risk and much greater regulatory risks than large water utilities.”¹⁹

The key consideration here is that an operating margin is not the same thing as a rate of return – indeed one look at the California Public Utility Commission's most recent order on rates of return and operating margins shows that the operating margin is about twice as large as the rate of return. To many people that will be bewildering – but what one must remember is that an operating margin is not the “return” for the investors and owners of a utility, it is simply what they have left after paying their operating expenses. Their operating margin is what they have available to deal with any operational or financial challenge – the California PUC explicitly takes “into account the high operational risks faced by Class C and D water utilities” and grants them operating margins nearly twice the size of a traditional rate of return – the reason is that a key “factor contributing to small water utility operating risk is their very high operating expenses to operating revenue factor.”²⁰

Again, bear in mind that a small system using an operating margin is, by definition, a system without significant rate base – it lacks financeable assets, thus it must operate on a cash flow basis. Any significant operational or financial challenge must be dealt with in cash, not financing. Therefore it is essential that operating margins for small systems be increased to levels at least similar to those in California's regulated industry.

Those first two steps, adjusting utility classifications to account for inflation (thus reducing the time and expense of rate case filings), and providing a healthy operating margin; will dramatically improve the ability of Arizona's small water and wastewater providers to deal with the environmental and regulatory challenges that lay in their near future.

Those steps will incent small water and wastewater utilities to file rate cases – allowing the Commission to begin getting a good look at the industry as it actually exists... Most of these systems haven't filed a rate case in decades, and the Commission frankly has no idea what their situation and strengths may be. By incenting the filing of rate cases, the Commission will get a real look at the small water situation in Arizona.

The effect of those two steps will be to make the industry healthier and more transparent. Both are essential to dealing with Arizona's water challenges, and to beginning to consolidate a highly fragmented industry.

Acquisitions are hampered not only by the lack of an acquisition adjustment incentive and the inability to consolidate rates (more on that later); they are also greatly hampered by the fact that many small systems are financially unhealthy and there is no real way to evaluate a company's position before one makes an offer and gets access to its books and records. Rate cases solve both those challenges and will make it easier for

¹⁸ See Attachment 2

¹⁹ “Water Utility Risk and Return”, Page 1

²⁰ Ibid, Page 16

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consolidators to evaluate and identify good acquisition opportunities, and to use real information to evaluate and negotiate a fair price.

Before concluding this section, we must highlight the fact that in Arizona, many small water companies have demonstrated very significant challenges interpreting and navigating the Corporation Commission's rate case process. This is not an indictment of the Arizona Commission, it is a common problem: "Many small water utilities have little or no contact with the Commission until they experience major fiscal or operational difficulties." That quote describes Arizona and many other states, but it is from "Water Utility Risk and Return" published by the California PUC, describing California's regulatory climate.²¹

Therefore we urge the Commission to consider establishing an Ombudsman office – staffed with an accountant, an engineer, and an attorney. The Ombudsman office would have two missions: First, to assist small companies after they file a rate case or a financing application; and second, to conduct outreach to the small water industry and to customers of small water systems to explain the Commission and its processes. They would not be there to represent the company but to assist them through the process. All too often, companies and customers are as confused as anyone by the Commission's work. That is in no one's interest.

Those steps, if combined with a Commission policy allowing rate consolidation, will lead to significant consolidation.

Should the Commission wish to further incent rate case filings, it could consider an incentive along the lines of this, again from "Water Utility Risk and Return":

"For whatever reason, many small utilities do not come in for needed rate increases. Allowing automatic rate adjustments which could be set to an index would allow the utility to recover those expenses that are out of the control of the utility. Therefore, the recovery of lost or gained revenues are not adjusted when the utility saves or wastes money and the stockholders will bear these gains or costs. Indexing will also preserve the incentives found with test year ratemaking."²²

An example of such an adjustment would be a power supply adjustor – allowing those, on a case by case basis, but only after the company files a rate case and gets Commission approval, could provide an additional incentive to file rate cases, and could also reduce small water companies operating revenue risk.

²¹ "Water Utility Risk and Return", Page 12

²² Ibid, Page 23

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SECTION FOUR: CONSOLIDATION OPPORTUNITIES

To achieve maximum economies of scale will require the Commission to begin consolidating rates within each utility, and consolidating the industry into larger more viable parent companies. These approaches will allow water systems to deal with unexpected costs and to attract capital on more reasonable terms. When one thinks about unexpected costs, most people think of well failures, but it also includes added and changed water quality regulations and standards, increasing costs for CAGR and CAP water, and increasing power costs. Additionally, changes to water quality standards, as occurred in the case of Arsenic, have significant costs and effects on customer bills. Consolidation of rates among affiliated systems and consolidation of the industry itself can mitigate those impacts.

Rate Consolidation

The first component of consolidation deals with consolidating the rates of affiliated systems. The Commission has consolidated the rates of affiliated systems in the past – notably Liberty Water's McLain and Sunrise systems in Cochise County; and the Commission has also deconsolidated the rates of affiliated systems – notably Anthem and Agua Fria in Maricopa County.²³ . In both cases, the Commission determination centered on customer rate impacts.

The electric, gas and telecommunications industries have long recognized that under rate consolidation more people have better service at a reasonable price. Under rate consolidation the regulatory process is also less cumbersome and expensive to both the public and the company involved. Consolidation avoids multiplicity of rate cases for each individual system, and simplifies the handling of questions and complaints by the regulatory commissions. And it strengthens the ability of utilities to withstand regulatory changes, environmental challenges, and economic challenges by spreading those costs over a larger, common, group of customers, i.e., by taking advantage of the economic fact that economies of scale exist.

One difference between the electric, gas and telecommunications industry and the water companies that must be addressed is that the other utilities customers all share common transmission systems. It would be necessary for the Commission to determine what factors are applicable in the water and wastewater consolidation decision. Factors may include but not be limited to common water resources, i.e., same aquifer, or common utility management, i.e., shared plant, shared services, common management, shared staff or future need for shared water sources, i.e. CAP or other surface water that requires large treatment systems.

As mentioned in the previous section, in order to achieve a wide spread, significant consolidation of the industry, rate base acquisition adjustments, allowance for regional consolidations, rate of return on equity premiums, cash flow and operating margin policies that strengthen small water companies must become tools that the Commission utilizes to encourage regional and integrated consolidation. This would allow the Commission greater flexibility to pick the tool that best fits the situation.

²³ We note that recently, another development, Corte Bella, has petitioned the Commission to deconsolidate themselves from Agua Fria, thus continuing to deconsolidate a once-regional operation.

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SECTION FIVE: SUMMARY AND RECOMMENDATIONS

In the final analysis, we believe that Arizona's environmental reality, and its expected population growth in areas served primarily by private water and wastewater utilities are sufficient justification for embarking on a Commission policy supporting and incenting consolidation of the private water industry. Arizona's water situation is not "dire" but it is, as it always has been, complex, challenging, and ever-changing. Knowing that the majority of small water systems lack financial and operational strength and knowing that Arizona's water situation is becoming more difficult is all the evidence the Commission needs to embark on a policy of consolidating and strengthening the industry before Arizona's population doubles in size.

But there are other benefits which we have also established in this paper: Customers will benefit from economies of scope and scale; the Commission will get a firmer grasp of the actual real-world financial and operational situation that small water companies face; the Commission will have greater oversight into the industry - and the industry itself will become much more transparent; and finally, Arizona residents will receive what Pennsylvania's PUC was able to attain for its residents: improved quality, reliability, and safety in their utility service.

Paul Walker
Chairman
Arizonans for Responsible
Water Policy

Pat Quinn
Director
Arizona Residential Utility
Consumers Office

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ATTACHMENT 1

Arizona Department of Water Resources

"Arizona's Next Century: A Strategic Vision for Water Supply Sustainability"

Executive Summary

January 2014

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January 2014

[ARIZONA'S NEXT CENTURY: A STRATEGIC VISION FOR WATER
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EXECUTIVE SUMMARY

The Challenge

For over a century, Arizonans have faced challenges in ensuring that there are sufficient and sustainable water supplies and have successfully developed water supplies for agricultural, industrial and domestic uses. Arizona has aggressively taken the actions necessary to ensure that sufficient and dependable water supplies are available for its long-term economic stability. While diverse, these actions have shared a common premise of being solution-oriented, meeting not only the immediate needs of the State, but more importantly addressing the future challenges Arizonans would face. Following in that tradition of strategic planning and action, Arizona now must face its next challenge in water supply security and management. We are at the crossroads of having to decide what actions we will take to meet those challenges.

Over the last five years, the Arizona Department of Water Resources (ADWR), in partnership with many in Arizona's water community has participated in the development of a comprehensive water supply and demand analysis for Arizona through the work of the Water Resources Development Commission (WRDC). At the same time, Arizona has also been actively working with the U.S. Bureau of Reclamation ("Reclamation") and the other six Colorado River Basin States (collectively, the "Basin States"), (see *Figure ES-1*) to identify projected supply and demand imbalances on the entire Colorado River system, culminating in the Colorado River Basin Water Supply and Demand Study ("Basin Study"). Through the work of the WRDC and the Basin Study, we have identified a long-term imbalance between available supplies and projected water demands over the next 100 years of up to 3 million acre-feet. Our challenge is to explore viable solutions to address this projected imbalance and initiate the action necessary to develop those solutions.

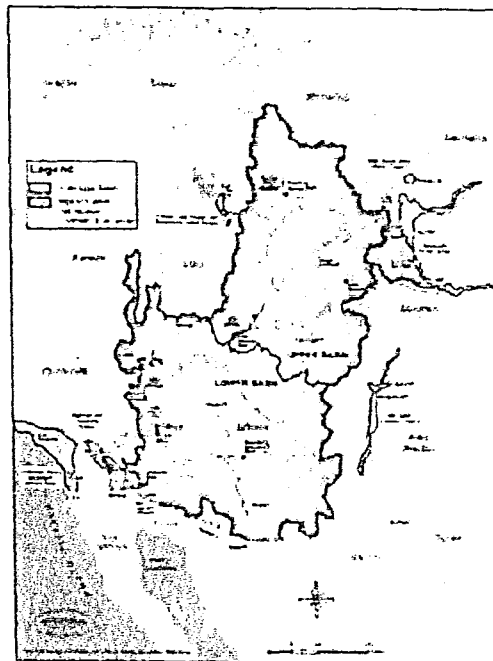


Figure ES-1. Colorado River Basin Study Area
(Reclamation, 2012)

The process to meet these challenges has already begun on two fronts. First, in cooperation with Reclamation and the other Basin States, ADWR (along with several Arizona stakeholders) is actively participating in a process to identify multiple Basin-wide solutions including: demand management; reuse of reclaimed or recycled water; analyzing the viability of water transfers; analysis of alternative water management strategies (e.g., Water Banking in the Upper Basin); watershed management; and importation of water supplies from outside of the Colorado River Basin. Secondly, at the request of Governor Jan Brewer, ADWR has initiated a parallel process within Arizona to develop a Strategic Vision

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that identifies possible strategies and projects to pursue to reduce these imbalances. This Strategic Vision creates the framework for analysis of potential strategies and provides context for maximizing them to address the needs of multiple water uses across the State.

This Strategic Vision for Arizona is a necessary first step in this process. We have completed the initial analysis of the challenges faced by Arizonans and have organized the State into twenty-two solution oriented "Planning Areas" (see Figure ES-2). The next logical step is to identify possible strategies to address projected imbalances. While many of the mechanisms necessary to address our future imbalances are available today, there are still limited supplies. A comprehensive Strategic Vision that identifies viable strategies will assist all water users in Arizona to come together to address our needs.

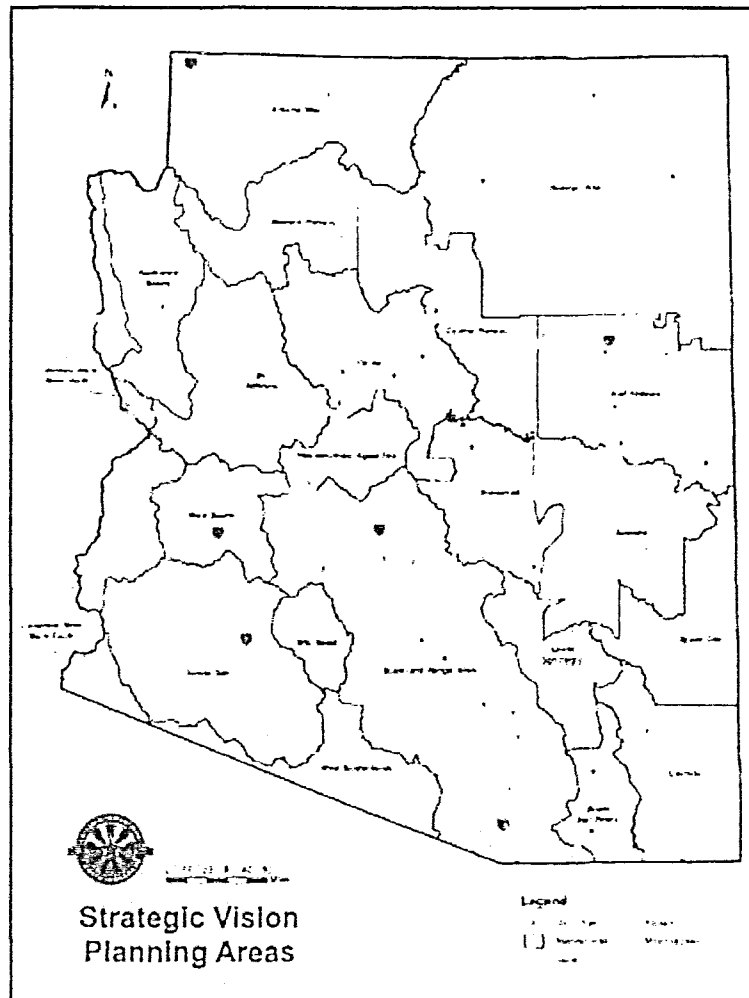


Figure ES-2. Strategic Vision Planning Areas

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History

While we reside in what some perceive as a harsh environment, those with great vision and leadership have harnessed the natural resources needed to support a thriving Arizona economy. This vision started well before statehood. First, beginning with the passage of the 1902 National Reclamation Act and the efforts of the Salt River Valley Water User's Association (SRP), over 200,000 acres of private ranching and farm lands in the Phoenix area was pledged as collateral for the construction of Roosevelt Dam in 1903, with a reservoir storage capacity of nearly 1.4 million acre-feet¹ (MAF) (see Figure ES-3). At the same time Central Arizona was harnessing the Salt River, development of the waters of the Colorado River was also taking shape, culminating over 50 years later, after a series of legal and political struggles, in the authorization of the Central Arizona Project (CAP) in 1968 (see Figure ES-4).

For decades Arizona's groundwater supplies were managed through the Court's until 1980, when the Arizona Legislature adopted one of the most comprehensive groundwater management strategies in the U.S. – the 1980 Groundwater Management Act (GMA). The framework of the GMA is intended to protect existing water users and serve new uses with non-groundwater supplies, preserving the groundwater supply as for future shortages. The GMA established a timeline for reduction and elimination of groundwater pumping in certain areas of the State; designating Active Management Areas (AMA) and Irrigation Non-Expansion Areas (INA) to facilitate this process (see Figure ES-5).

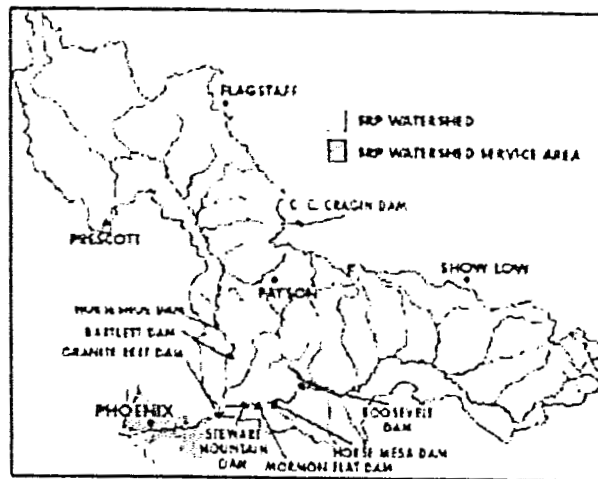


Figure ES-3. Salt River Project Reservoir System and Service Area (Courtesy of SRP)

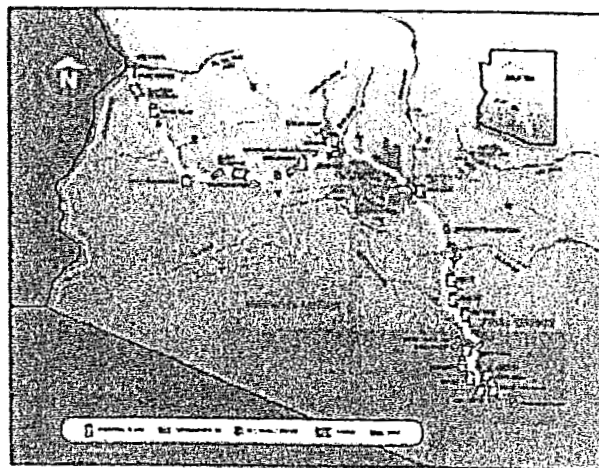
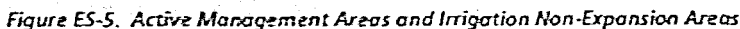


Figure ES-4. Central Arizona Project System (Courtesy of CAP)

¹ From 1959 to 1996, the dam was modified by the US Bureau of Reclamation. In addition to raising the dam's height 77 feet in elevation, the modification included construction of two new spillways, installation of new outlet works, and power plant modifications, increasing its water conservation storage capacity by 20 percent.

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mandatory water conservation requirements, Arizona has seen significant improvement in water use efficiencies, as illustrated in Figure ES-6, below.

Arizona, along with California, Florida, and Texas, also leads the nation in utilization of reclaimed water¹. A significant portion of the reclaimed water produced in Arizona is reused for landscape irrigation, agricultural irrigation, power generation, irrigation of parks and schools and artificially recharged into groundwater aquifers. A portion of the reclaimed water is also discharged into the beds of rivers and streams, benefiting the environment by providing habitat for wildlife and adding aesthetic and economic value to Arizona's landscape.

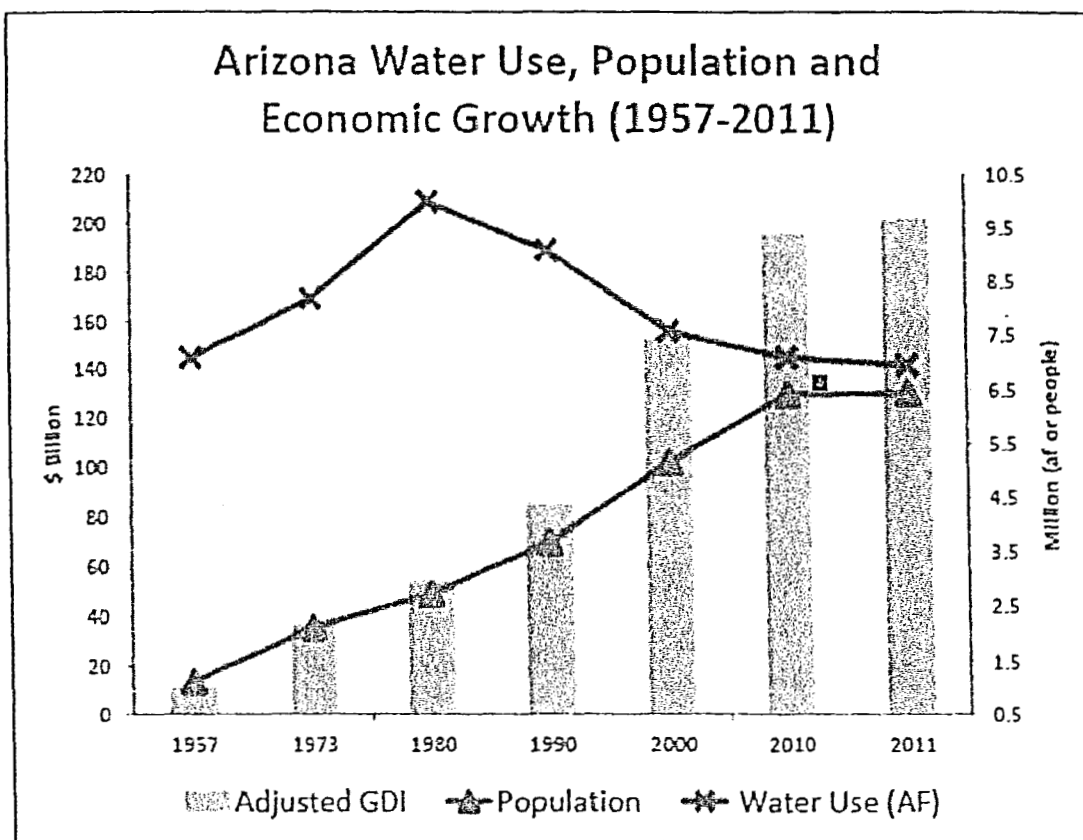


Figure ES-6. Arizona Water Use, Population and Economic Growth 1957 - 2011 (ADWR, 2013)

As development expanded throughout Arizona and as the State moved closer to full utilization of its diverse water portfolio, Arizonans adopted dynamic water management strategies to address the issues they encountered, including Underground Storage and Recovery and Water Banking of unused supplies, adoption of 100-year Assured Water Supply Rules for all new development, and the creation of the Central Arizona Groundwater Replenishment District (CAGRDR) to meet the needs of communities without direct access to renewable water supplies.

¹ Water and Wastes Digest @ <http://www.wwdmag.com/EPA-Releases-Updated-Version-of-Guidelines-for-Water-Reuse-article6636>

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The achievements outlined above serve as a guide for future planning as they are the result of strong commitments and significant investments in time and money to realize the benefits of the projects. Establishing and pursuing a vision for water security for future generations of Arizonans must begin well in advance of the need in order to ensure orderly development, avoid economic disruption, and protect the unique and precious environment that we all enjoy. Many of the elements of Arizona's water development history were shaped by creative public/private partnerships. Such arrangements are likely to become more common and necessary, as the federal government's role in water development projects continues to evolve.

Future Water Supplies & Demands

The current challenge facing Arizona is that, although the State has an existing solid water management foundation, water demands driven by future economic development are anticipated to outstrip existing supplies. Additionally, the availability of surface water supplies have been reduced in recent years as drought conditions have been experienced locally and throughout the Colorado River Basin. Questions about future climate conditions add additional uncertainty to our ability to maintain an appropriate balance between demands and supply. Water resource planning efforts are instrumental in the identification and evaluation of these challenges. Arizona has been actively evaluating future water supply and demand conditions for decades.

Every ten years, consistent with State statute, ADWR assesses water supply and demand conditions in each of the State's AMAs, primarily to evaluate the ability to achieve the management goals identified by the Legislature for each AMA under the GMA. In 2009 and 2010, in anticipation of the next Management Plan, ADWR developed a demand and supply assessment for each of the five AMAs to: (1) evaluate its current status and ability to achieve the statutory water management goals for these five areas and (2) to frame the discussions for alternative management strategies needed to meet and maintain those goals. Additionally, ADWR also produced the Arizona Water Atlas (Atlas) in 2010 providing water-related information on a local, regional and statewide level to frame and support water planning and development efforts. The development of the Atlas also spurred the development of a statewide water resources data repository housed at ADWR, which is continuously updated as water use information is reported and collected. These are on-going efforts that allow both for focus on specific regions of the State and provide past and present water use information.

Since 1980, Arizona has also developed, or partnered in, comprehensive and prospective statewide and multi-state planning efforts (a list of these efforts is identified in Appendix III of the Strategic Vision). More recently, the WRDC was an Arizona-only effort identifying projected future statewide water demands and available water supplies for the next 100 years. Estimates for population growth in Arizona for the years 2035, 2060 and 2110 are 10.5, 13.3 and 18.3 million people, respectively. Annual water demand is expected to grow from current levels of 6.9 MAF to between 8.2 and 8.6 MAF in 2035, between 8.6 and 9.1 MAF in 2060 and between 9.9 and 10.5 million acre-feet per year in 2110.

The Basin Study was developed to define current and future imbalances between projected demands and Colorado River water supply availability in the Colorado River Basin and the adjacent areas that receive water from the Colorado River, through 2060. This extensive study estimated that population within the study area is projected to increase from about 40 million people in 2015 to between 49.4 million and 76.5 million people under the slow growth and a rapid growth scenario, respectively. As a

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result of this increased population, and factoring in Mexico's 1.5 MAF 1944 Treaty allotment and losses due to evaporation and system operations, projected demands in the Basin are anticipated to range between 18.1 MAF (slow growth scenario) and 20.4 MAF (rapid growth scenario). Over the past 10 years, the Colorado River's yield has averaged about 15.3 MAF annually. Comparing the median water demand projections to the median water supply projections, the long-term projected Basin-wide imbalance is estimated to be 3.2 MAF by 2060. The actual imbalance may be much larger, or could be slightly smaller, depending on the availability of water and actual growth experienced in the region.

Opportunities & Challenges

Arizona is characterized by widely diverse geographic zones, ranging from forested mountains to arid deserts. These areas have dissimilar climates and precipitation regimes, resulting in great variability in, and accessibility to, surface water supplies. Arizona is also geologically complex, which impacts the availability, quality and accessibility of groundwater supplies. Arizona is also unique in its land ownership patterns. Less than 18 percent of the land within the State is under private ownership. State Trust Land, administered by the Arizona State Land Department (ASLD) comprises almost 13 percent of the land, with the remaining 69 percent in either Federal or Indian ownership (see Figure ES-7). This ownership is also often fragmented, with Federal, State, and private land holdings assembled in a "checkerboard" fashion that further complicates the development and execution of comprehensive and cohesive land and water management strategies.

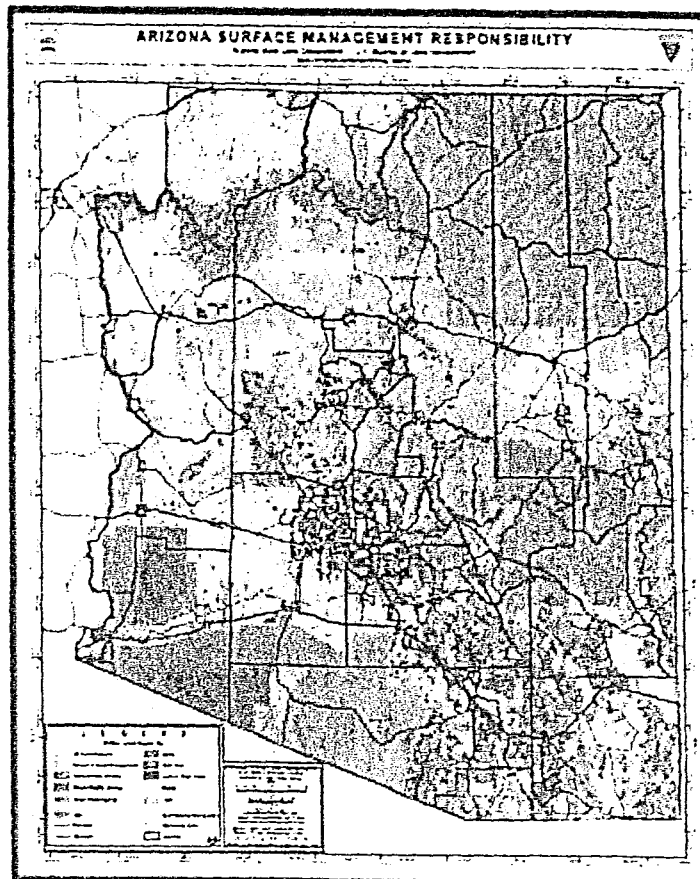


Figure ES-7. Arizona Land Ownership (Courtesy ASLD)

Another factor in the complexity of developing water supplies is the Arizona water law system, a complex mixture of State and federal laws, with groundwater and surface water largely regulated under separate statutes and rules. While the groundwater management system primarily applies inside designated AMAs and INAs, the surface water system (except for Colorado River supplies) is administered statewide. Colorado River supplies are managed in cooperation with the State, but contracts for Colorado River water are initiated through the US Secretary of the Interior and

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administered by Reclamation. Reclaimed water is managed under a completely different set of regulations and policies, and its management framework was significantly influenced by case law³. This legal complexity adds to the challenge of ensuring that adequate supplies exist to meet the demands across the state.

Further adding to the legal complexities within the State are the on-going general stream adjudications of the Gila and Little Colorado Rivers. General stream adjudications are judicial proceedings to determine or establish the extent and priority of water rights. The Gila River and the Little Colorado River adjudications were initiated in 1974 and include water uses and claims by both state and federal entities. The State parties include municipalities, mines, utility companies, private water providers, water users' associations, conservation districts, irrigation districts, state agencies and individual water users that rely on water diverted from streams, lakes, springs, stored in reservoirs or stockponds, and withdrawn from wells. Within these proceedings, water rights are also being adjudicated for water uses on Indian reservations and federal lands including military installations, conservation areas, parks and forests, monuments, memorials, and wilderness areas. These water uses may include both surface water (non-Colorado River) and groundwater in certain instances. As of July 2013, there are 83,244 surface water claims in the Gila River Adjudication and 14,522 claims in the Little Colorado River Adjudication. While progress on the adjudication process has been complicated by the diversity of water users and claimants, the State has made significant progress in reducing uncertainty through execution of Indian Settlements resolving in whole or in part 13 of the 22 tribal claims through Court Decrees or negotiations culminating in Congressionally authorized settlements.

Over the next 25 to 100 years, Arizona will need to identify and develop an additional 900,000 to 3.2 MAF of water supplies to meet the projected water demands. While there may be viable local water supplies that have not yet been developed, water supply acquisition and/or importation will be required for some areas of the State to realize their growth potential. Examples of these potential supplies are:

- 1) Non-Indian Agricultural Priority CAP water;
- 2) Reclaimed water/water reuse for which there is not yet delivery or storage infrastructure constructed to put it to direct or indirect use;
- 3) Groundwater in storage (both potable & brackish supplies);
- 4) Water supplies developed from revised watershed management practices;
- 5) Water supplies developed through weather modification;
- 6) Water supplies developed from large-scale or macro rainwater harvesting/stormwater capture; and
- 7) Importation or exchange of new water supplies developed outside of Arizona (e.g., ocean desalination).

Strategic Vision

Arizona could be facing a water supply imbalance between projected demands and water supply availability approaching 1 million acre-feet in the next 25 to 50 years. In many portions of the State, this short term imbalance can likely be solved with enhanced management of locally available water supplies. However, there is still a need to develop the financing to construct the infrastructure

³ *Arizona Public Service Co. v. Long*

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necessary to accomplish this. The imbalance is projected to increase by an additional 2.3 MAF by the year 2110. The availability of local water supplies to meet these needs will vary based on the distribution and intensity of the demands throughout each region of the State. The stresses imposed by these imbalances would be experienced by all water using sectors in the State and would likely have undesirable environmental consequences.

Local water supplies may not be sufficient to address these longer term needs and more options must be explored and evaluated, including importation of new water supplies from outside of Arizona. Pursuit of long-term options will require sustained investment and commitment by Arizona's policy and business leaders. In order to avoid economic disruption, these efforts must begin immediately to ensure the long-term solutions are in place in advance of the need and the environment that makes Arizona unique is adequately and appropriately protected.

Regional Strategies

No single strategy can address projected water supply imbalances across the State. Instead a portfolio of strategies needs to be implemented dependent on the needs of each area of the State. It is very important to recognize the uniqueness of the various regions throughout the State and the varying challenges facing those regions. A more thorough regional overview and evaluation of the water supply needs is required for each of the twenty-two "Planning Areas" within Arizona and is contained in Section III of the Strategic Vision. These Planning Areas (see *Figure ES-2*) have been identified based on possible short-term and long-term strategies available to meet the projected water supply imbalances. Table ES-1, below, highlights the portfolio of strategies that have been identified and the applicability to each of the Planning Areas. Many of the necessary planning efforts are well underway in some regions.

Statewide Strategic Priorities

In analyzing all the strategies on a regional basis it became clear that there are specific measures that have widespread potential benefit to all Arizonans. Strategic priorities are identified below which ADWR believes will move Arizona forward through its next century. Additionally, action items have been identified for the first 10 years following the submittal of this report including a requirement for the continued review and update of this report every 10 years.

The identified statewide strategic priorities are:

1) Resolution of Indian and Non-Indian Water Rights Claims

Arizona has been successful in resolving, either in whole or in part, 13 of 22 Indian water rights claims, providing substantial benefits to both Indian and non-Indian water users. However, the general stream adjudications, which began in the 1970s, remain incomplete. Completion of the general stream adjudication will result in the Superior Court issuing a comprehensive final decree of water rights. Until that process is complete, uncertainty regarding the nature, extent and priority of water rights will make it difficult to identify all the strategies necessary for meeting projected water demands. ADWR believes that options need to be developed by the State to accelerate this process. Creation of a Study Committee to develop options in a short time frame could help provide guidance to ADWR so adequate funding can be identified and obtained to complete the necessary technical work to support completion of this process. Development of options could initially focus on conceptualization of water rights administration in a post-adjudicated Arizona. This will streamline the Court and ADWR's effort to

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collecting and evaluating only that information what will assist in administering the final water rights decrees.

2) Continued Commitment to Conservation and Expand Reuse of Reclaimed Water

Conservation is the foundation of sustainable water management in our arid State. The continued commitment to using all water supplies as efficiently as possible is necessary to stretch our existing water supplies and has delayed the need to acquire other, more expensive, supplies. Additionally, many non-potable uses are currently being met by reclaimed water including: landscape irrigation of parks and golf courses; agricultural irrigation; and streamflow augmentation benefitting ecosystems. Reclaimed water is produced consistently throughout the year, with limited seasonal fluctuation. Using reclaimed water limits use of potable water for non-potable purposes and saves potable water for drinking water supplies. However, as demands increase and water supplies become more stretched, the need to explore and invest in direct potable reuse for drinking water supplies will become necessary.

3) Expanded Monitoring and Reporting of Water Use

Metering and reporting across the State would serve to support and enhance analysis of current hydrologic conditions. However, monitoring of water use outside of the AMAs and INAs is limited. Data collection is a crucial element of the development of groundwater models, which have proven to be invaluable tools throughout the State in developing more thorough understanding of hydrologic systems and evaluating future conditions and potential impacts of new uses and/or alternative water management strategies.

4) Identifying the Role of In-State Water Transfers

A source of significant controversy across the State, in-State water transfers have been the focus of much debate throughout Arizona's history. A comprehensive analysis of water transfer is needed in Arizona. Evaluation of long-term versus short-term transfers may actually provide insight into how water transfers can be developed to protect or even benefit local communities. Lessons from other western states that have adopted more market-based water right transfer models may be worthy of review as part of this analysis.

5) Supply Importation – Desalination

Importation of water from outside of Arizona will likely be required to allow the State to continue its economic development without water supply limitations. Supplies derived from ocean or sea water desalination can be imported directly into Arizona to meet the water needs of municipal and industrial water users, while at the same time providing aesthetic, recreational and ecological benefits. Alternatively, desalination can be done in partnership with other Colorado River water users in exchange for water from Lake Mead. Potential partners for seawater desalination include higher priority Colorado River entitlement holders in Arizonan and California, the State of California, or Mexico. Projects of this magnitude are expensive and energy intensive, although unit capital and operating costs have significantly reduced as technology has improved and are comparable to water rates in other parts of the country. More importantly, because of the need to identify partners and develop agreements, such projects will require a significant investment of time – up to 20 years to bring to fruition. Because of the time it takes to develop these projects, and the more pressing need for water supplies in certain parts of the State, exploration of this strategy should begin immediately.

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6) Develop Financing Mechanism to Support Water Supply Resiliency

The strategies identified above, both statewide and regional, will require capital investment. Some areas of the State need immediate assistance in developing water projects, specifically in portions of rural Arizona. Unfortunately, these are areas where limited populations cannot finance the required water infrastructure. The Water Resources Development Revolving Fund was created by the Arizona State Legislature to provide financial backing for these communities, but has not been funded to date. Seed money for this revolving fund will be very important to meet the immediate needs of rural communities and provide long-term water supply security for many Arizonans.

Financing of large-scale projects is another issue. For many years, the water community has been attempting to develop options for funding water supply acquisition and infrastructure development. These conversations and analyses have largely been conducted in the absence of substantial financial expertise and have achieved limited success. It is time to elevate this conversation and address Arizona's future water supply needs and only Arizona's community, political, and business leaders are capable of garnering financial resources and mechanisms necessary to meet these needs. While the water supply needs may not be immediate, addressing the financing of future large-scale water projects needs to begin as soon as possible to ensure Arizona's industries and citizens have secure water supplies into the future.

10-Year Action Plan Outline

- Legislate Strategic Vision update every 10 years (Year 1)
- Begin Discussions on Ocean Desalination (Year 1)
 - Exchange Options
 - California
 - Mexico
 - Direct Options
 - Mexico
- Resolve ADOT Right-of-Way Issues for utilities (Year 1)
- Establish Adjudication Study Committee (Year 1)
- Begin Discussions on Water Development Financing (Year 2)
 - Immediate Needs for Water Resources Development Revolving Fund for rural Arizona
 - Long-Term Needs for Large-Scale water importation projects
- Remove current statutory limitation (A.R.S. § 45-801.01(22)) on the ability to receive long-term storage credits for recharging reclaimed water beyond 2024 (Year 2)
- Review Legal and Institutional Barriers to Direct Potable Reuse of Reclaimed water – develop and implement plan for resolution (Year 3)
- Review and implementation of Adjudication Study Committee Findings (Year 3)
- Develop and Begin Implementation of Direct Potable Reuse of Reclaimed Water Public Perception Campaign (Year 4)
- Begin discussions with New Mexico on an interstate cooperative program for watershed management/weather modification in the Upper Gila watershed (Year 4)
- Resolve Remaining Indian Settlements (Year 1 - 10)
- Resolve General stream Adjudication (Year 5 - 10)

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Table ES-1. Planning Area Strategies

Strategy	Applicable Planning Area(s)*	Supply Limitation	Drought Resiliency	Implementation Challenge	Timeline**	Planning Area Key	
						ID	Name
Reclaimed Water Reuse	1, 3, 5, 6, 9, 14, 15, 17, 18, 19, 20, 22, 24	Derivative Supply increases w/ Growth	Yes	Low to Moderate Cost Perception of Direct Use	C/EEP to Short	1	Apache
Conservation	All Planning Areas	Potential Limited by Existing Programs	Yes	Low	C/EEP to Short	2	Arizona Strip
Weather Modification	1, 3, 9, 16, 17, 18				Med	3	Basin & Range AMAZ
Watershed/Forest Management	1, 3, 5, 9, 14, 16, 17, 18, 19		Some		Med	4	Big Bend
Expanded Monitoring & Reporting of Water Use	All Planning Areas	N/A Assists in Managing Existing Supplies	N/A	Moderate Consent of Ungrazed Parties Required	Short	5	Central Plateau
Resolution of Indian and Non-Indian Water Rights Claims/Settlement Implementation	1, 3, 4, 9, 10, 12, 13, 14, 16, 17, 18, 19, 22	N/A Reduced Supply Uncertainty	Supply Dependent			6	Cochise
Increased Access to Locally Available Groundwater (Potable & Brackish) & Enhanced Recharge	1, 3, 5, 9, 14, 15, 18, 19, 20	Moderate Need Additional Studies to Confirm	Yes Short Term Drought	Moderate Securing Supplies & ROW Access	Short to Med	7	Colorado River Mainstem - North
Local Water Supply Study - Groundwater System Analysis/Modeling	1, 2, 4, 6, 9, 10, 11, 14, 15, 17, 20, 22	N/A Assists in Managing Existing Supplies	Gain Local Knowledge of GW/SW Link	Low - Moderate But Resources and Data Collection Needed	Short to Med	8	Colorado River Mainstem - South
Local Water Supply Management	6, 18	N/A	Supply Dependent		Med	9	Rock Process
Firming of Low Priority Colorado River Supplies	3, 7, 20		Yes	Low - Moderate Existing Authority But Resources Limited	C/EEP to Short	10	San Bernardino
Importation - In-state SW or GW	3, 5, 16, 18		Supply Dependent	Moderate - High Some SW already avail. Public Opposition Likely	Med to Long	11	San Joaquin
Importation - Desal Exchange	3, 12, 18	Limited by Exchange Opportunities and Infrastructure	Exchange Supplies Limited			12	San Luis
Importation - Desal Direct Use	3, 12, 18	Supply Unlikely as Economics will drive capacity	Yes			13	San Pedro
	3					14	Verde
						15	West Basins
						16	West Borderlands
						17	Western Plateau
						18	
						19	
						20	
						21	
						22	

* Applicable Planning Area - BOLD are areas where strategy is recommended - Italicized are areas where strategy could be utilized but not a primary option

Recommended Implementation Schedule:
C/EEP = Construction/Execution of Existing Programs
Short = Short-Term (< 5 yrs)
Med = Medium-Term (5 - 15 yrs)
Long = Long-Term (> 15 yrs)

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Conclusion

Just as many of Arizona's greatest historic accomplishments have been directly linked to water, Arizona's future success is tethered to how effectively we continue to manage our water resources and develop new water supplies and infrastructure. Yet, our present success cannot sustain Arizona's economic development forever and we must continue to plan and invest in our water resources. The diversity, variability and complexity that are unique to Arizona make developing water supply strategies difficult. In some places, there may be local water supplies that have not yet been developed. However, it is now clear that water supply acquisition and/or importation will be required for some areas of the State to realize their growth potential. While there are local areas that require more immediate action, the State as a whole has the good fortune of not facing an immediate water crisis. Now is the time to begin addressing this challenge by implementing this Strategic Vision for Arizona's water future. The lack of an immediate problem increases the potential for inaction, running the risk of procrastination and not sufficiently motivating ourselves to plan and invest in our future. Governor Brewer's foresight in calling for the development of a Strategic Vision for Water Supply Sustainability for Arizona is essential to guide and ensure our economic stability into the next century.

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ATTACHMENT 2
California Public Utility Commission
Rate of Return and Operating Margin Policy

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

STATE OF CALIFORNIA

Edmund G. Brown Jr. Governor

PUBLIC UTILITIES COMMISSION

300 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3224



March 21, 2014

RE: Rates of Return and Rates of Margin for Class C and Class D Water Utilities

TO: COMMISSION

By this memorandum, the Division of Water and Audits (DWA) updates its recommended Rates of Return and Rates of Margin for Class C and D water utilities.¹ These updates have been calculated in accordance with Resolution W-4524, which revised the Standard Practice that addresses how the rate of return and rate of margin are calculated for Class C and D water utilities.

DWA considered a number of factors in determining the rates of return. DWA assessed the movement in actual and forecasted interest rates over the last year's (lower actual rates that are forecast to recover to near recent historical). In addition, DWA took into account the high operational risks faced by Class C and Class D water utilities and the constant level of authorized rates of return for Class A water utilities in 2014 over 2013 (average of 8.51% and 8.79%, respectively).

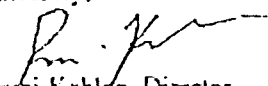
In determining the rates of margin for Class C and D water utilities, DWA considered the Class B water utilities most recent authorized average rates of return of 10.10%, their most recent authorized equivalent average rate of margin of 19.38%, and the recommended rates of return for Class C and D water utilities, as calculated.

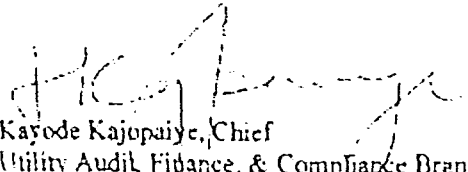
For 2014, DWA recommends that the following rates of return and rates of margin be used for Class C and Class D water utilities informal general rate cases (supporting documentation is attached):

	Rates of Return (ROR)	Rates of Margin (ROM)
Class C	10.20% to 11.20%	20.54%
Class D	10.80% to 11.80%	21.69%

If you have any questions regarding the Rates of Return or Rates of Margin recommendations, please contact Khai Duong of the Division of Water and Audits at (415) 703-2799, or kduong@cpuc.ca.gov.

Sincerely,


Rami Kahlon, Director
Division of Water and Audits


Kayode Kajopaiye, Chief
Utility Audit, Finance, & Compliance Branch

Attachment

¹ As required by D.92-03-093, in Phase I of L.90-11-033 (Water Risk OII).

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CALCULATION OF CLASS C & D WATER COMPANY² RATES OF RETURN (ROR) & RATES OF MARGIN (ROM)¹

- Rates are calculated using both return-on-ratebase and rate of margin methods.
- The method that produces the higher result is used
- ROR is set at a level above or below the recommended ranges, if warranted.
- Where little or no rate base exists, the ROM is used.
- The ROM is applied to Operating Expenses to determine the estimated dollar return, which is then compared with the average dollar ROR on rate base.
- Calculations are based on the assumption that there is a comparable relationship between authorized Class B ROR and ROM and Class C and D ROR and ROM.
- Class C and D water operations, finances, and risks are more similar to those of the Class B water companies, than with Class A water utilities.

Data Used in Determining the Rates of Return and Rates of Margin for Class C and Class D Water Utilities

Year	Recommended ROR Range		Actual Interest Rates from the Federal Reserve			
			U.S. Treasuries			
	Class C Water	Class D Water	90-Day	1-Year	5-Year	30-Year
2012	10.50% - 11.50%	11.25% - 12.25%	0.09%	0.17%	1.76%	2.92%
2013	10.30% - 11.30%	11.00% - 12.00%	0.06%	0.13%	1.17%	3.45%
2014 (As of 02/2014)	10.20% - 11.20%	10.80% - 11.80%	0.05%	0.12%	1.52%	3.66%
			Forecast Interest Rates from IHS Global Insight			
Forecast for 2015 (As of 02/2014)			0.41%	0.64%	1.91%	4.25%

Calculation of Rate of Margin ("ROM")	Inputs	ROM	
		Class C	Class D
Average Class B Rate of Margin ("ROM")	19.38%		
Average Class B Rate of Return ("ROR")	10.10%		
Average Class C ROR	10.70%		
Average Class D ROR	11.30%		
Average Class C ROM - Average Class B ROM * (Average Class C ROR / Average Class B ROR)		20.54%	
Average Class D ROM - Average Class B ROM * (Average Class D ROR / Average Class B ROR)			21.69%

¹ Class C water utilities have 501 to 2,000 customers; Class D water utilities have 500 or less customers.

² Pursuant to D.92-03-093, Ordering Paragraph 8 and Resolution W-4524.

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ATTACHMENT 3
Pennsylvania Public Utility Commission
Policy on Water Acquisitions

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SMALL NONVIABLE WATER AND WASTEWATER SYSTEMS—STATEMENT OF POLICY

§ 69.711. Acquisition incentives.

(a) *General.* To accomplish the goal of increasing the number of mergers and acquisitions to foster regionalization, the Commission will consider the acquisition incentives in subsection (b). The following parameters shall first be met in order for Commission consideration of a utility's proposed acquisition incentive. It should be demonstrated that:

- (1) The acquisition serves the general public interest.
- (2) The acquiring utility meets the criteria of viability that will not be impaired by the acquisition; that it maintains the managerial, technical and financial capabilities to safely and adequately operate the acquired system, in compliance with 66 Pa.C.S. (relating to the Public Utility Code), the Pennsylvania Safe Drinking Water Act (35 P. S. § § 721.1—721.17) and other requisite regulatory requirements on a short and long-term basis.
- (3) The acquired system has less than 3,300 customer connections; the acquired system is not viable; it is in violation of statutory or regulatory standards concerning the safety, adequacy, efficiency or reasonableness of service and facilities; and that it has failed to comply, within a reasonable period of time, with any order of the Department of Environmental Protection or the Commission.
- (4) The acquired system's ratepayers should be provided with improved service in the future, with the necessary plant improvements being completed within a reasonable period of time.
- (5) The purchase price of the acquisition is fair and reasonable and the acquisition has been conducted through arm's length negotiations.
- (6) The concept of single tariff pricing should be applied to the rates of the acquired system, to the extent that it is reasonable. Under certain circumstances of extreme differences in rates, or of affordability concerns, consideration should be given to a phase-in of the rate difference over a reasonable period of time.

(b) *Acquisition incentives.* In its efforts to foster acquisition of suitable water and wastewater systems by viable utilities when the acquisitions are in the public interest, the Commission seeks to assist these acquisitions by permitting the use of a number of regulatory incentives. Accordingly, the Commission will consider the following acquisitions incentives:

- (1) *Rate of return premiums.* Under 66 Pa.C.S. § 523 (relating to performance factor considerations), additional rate of return basis points may be awarded for certain acquisitions and for certain associated improvement costs, based on sufficient supporting data submitted by the acquiring utility

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within its rate case filing. The rate of return premium as an acquisition incentive may be the most straightforward and its use is encouraged.

(2) *Acquisition adjustment.* When the acquiring utility's acquisition cost differs from the depreciated original cost of the water or wastewater facilities first devoted to public use, the difference may be treated as follows for ratemaking purposes:

(i) *Credit acquisition adjustment.* Under 66 Pa.C.S. § 1327(e) (relating to acquisition of water and sewer facilities), when a utility pays less than the depreciated original cost of the acquired system, the acquiring utility may book and include in rate base the depreciated original cost of the acquired system, provided that the difference between the acquisition cost and depreciated original cost should be amortized as an addition to income over a reasonable period of time or be passed through to ratepayers by another methodology that is determined by the Commission. The acquiring utility may argue that no amortization or pass through is appropriate when the acquisition involves a matter of substantial public interest.

(ii) *Debit acquisition adjustment.* Under 66 Pa.C.S. § 1327(a), when a utility pays more than the depreciated original cost of the acquired system, the acquiring utility may book and include in rate base the excess of acquisition cost over depreciated original cost of the acquired system, provided that the utility can meet the requirements of 66 Pa.C.S. § 1327(a). When the acquisition does not qualify under 66 Pa.C.S. § 1327(a), the debit acquisition adjustment should be treated in accordance with generally accepted accounting principles and not be amortized for ratemaking purposes.

(3) *Deferral of acquisition improvement costs.* In cases when the plant improvements are of too great a magnitude to be absorbed by ratepayers at one time, rate recovery of the improvement costs may be recovered in phases. There may be a one time treatment—in the initial rate case—of the improvement costs but a phasing—in of the acquisition, improvements and associated carrying-costs may be allowed over a finite period.

(4) *Plant improvement surcharge.* Collection of a different rate from customers of the acquired system upon completion of the acquisition could be implemented to temporarily offset extraordinary improvement costs. In cases when the improvement benefits only those customers who are newly acquired, the added costs may be allocated on a greater than average level—but less than 100%—to the new customers for a reasonable period of time, as determined by the Commission.

(c) *Procedural implementation.*

(1) An acquiring utility that has met the criteria set forth in 66 Pa.C.S. § 1327(a)(1)—(9) for inclusion of a debit acquisition adjustment in its rate base, may elect to have this acquisition adjustment considered on a case-by-case basis as set forth in 66 Pa.C.S. § 1327(b), or as part of its next rate case filing. The acquiring utility should file the supporting documentation outlined in subsection (d) to support the requested acquisition adjustment.

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(2) The appropriate implementation procedure to qualify for the other acquisition incentives in subsection (b) would be to file the appropriate supporting documentation during the next filed rate case.

(3) In acquisition incentive filings, the burden of proof rests with the acquiring utility.

(d) *Documentation to support inclusion of acquisition adjustment.* When an acquiring utility elects to have the acquisition adjustment to its rate base considered as a part of its next rate case filing, the acquiring utility should file the following documentation to support the acquisition adjustment to its rate base:

(1) *Statement of reliance on existing records.* An acquiring utility may elect to rely in whole or in part upon the original cost records of the seller or Commission in determining the original cost of the used and useful assets of the acquired system.

(2) *Preparation of data to support acquisition adjustment.* An acquiring utility, upon its own election, may file an original cost plant-in-service study with the Commission to support its requested acquisition adjustment to its rate base. An original cost study is one method of determining the valuation costs of the property of a public utility. It requires the acquiring utility to develop realistic plant balances and accumulates the records and accounting details that support those balances. Disputes regarding the acquiring utility's original cost valuation of the assets of the acquired system will be resolved in the context of a rate proceeding when interested parties will have an opportunity to be heard.

(i) *Contents of an original cost plant-in-service study.* When an acquiring utility elects to submit its own original cost of plant-in-service valuation, the acquiring utility is obligated to exercise due diligence and make reasonable attempts to obtain, from the seller, documents related to original cost. In particular, as part of its exercise of due diligence, the acquiring utility should request from the seller, for purposes of determining the original cost plant-in-service valuation, the original cost of the assets being acquired and records relating to contributions in aid of construction (CIAC), such as the following:

(A) Accounting records and other relevant documentation and agreements of donations or contributions, services, or property from states, municipalities or other government agencies, individuals, and others for construction purposes.

(B) Records of unrefunded balances in customer advances for construction (CAC).

(C) Records of customer tap-in fees and hook-up fees.

(D) Prior original cost studies.

(E) Records of local, State and Federal grants used for construction of utility plant.

(F) Relevant PennVEST or Department of Environmental Protection records.

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(G) Any Commission records.

(H) Summary of the depreciation schedules from all filed Federal tax returns.

(I) Other accounting records supporting plant-in-service.

(ii) *Failure of seller to provide cost-related documents.* The failure of a seller to provide cost-related documents, after reasonable attempts to obtain the data, will not be a basis for the Commission's denial of the inclusion of the value of the acquired system's assets in its proposed rate base. Because the documents obtained from the seller may be incomplete and may result in an inaccurate valuation, the acquiring utility will not be bound by the incomplete documents from the seller in the preparation of its original cost plant-in-service valuation.

(iii) *Procedure for booking CIAC.* The acquiring utility, at a minimum, should book as CIAC contributions that were properly recorded on the books of the system being acquired. If evidence supports other CIAC that was not booked by the seller, the acquiring utility should make a documented effort to determine the actual CIAC and record the contributions for ratemaking purposes, such as lot sale agreements or capitalization vs. expense of plant-in-service on tax returns.

(iv) *Plant retired/not booked/not used and useful.* The acquiring utility should identify all plant retirements and plant no longer used and useful, and complete the appropriate accounting entries.

(v) *Reconciliation with commission records.* In the case of an acquisition of a water or wastewater system that is regulated by the Commission, the acquiring utility should reconcile and explain any discrepancies between the acquiring utility's original cost plant-in-service valuation and the Commission's records, to the extent reasonably known and available to the acquiring utility, at the same time the supporting documentation for the study is filed.

(e) *Time to submit original cost valuation.* When the acquiring utility elects to request an acquisition adjustment during its next rate filing, it should submit a copy of its newly prepared original cost plant-in-service valuation of the acquired system or a statement of reliance of the existing records of the Commission or the seller to the Commission's Secretary's Bureau, the Bureau of Audits, the Bureau of Fixed Utility Services, the Office of Trial Staff, the Office of Consumer Advocate, and the Office of Small Business Advocate at least 4 months prior to the date that the acquiring utility plans to make its next rate case filing with the Commission.

(1) The Commission staff may conduct an audit of the original cost valuation, but if no staff audit is completed and released at public meeting before the date of the rate case filing, the Commission's determination of the original cost valuation in the rate case will be deemed final action on the original cost valuation and any associated acquisition adjustment, absent subsequently discovered fraud or misrepresentation. When staff completes an audit before the rate case is filed, the results of the audit will not be binding on any party, but rather the audit report will be made available to the public and the report can be presented in the acquiring utility's next rate case, subject to applicable evidentiary rules.

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(2) When the acquiring utility makes a rate case filing sooner than the 4-month window, the acquiring utility should not include any revenues or expenses related to the acquisition, including the requested acquisition adjustment in its proposed rate base unless it includes the original cost valuation with the rate filing and one of the following circumstances applies:

- (i) A compelling reason exists for requesting the acquisition adjustment in the current rate filing.
- (ii) The acquisition was requested or otherwise directed by the Commission.
- (iii) No statutory party objects to the inclusion of the acquisition adjustment to the proposed rate base of the acquiring utility.

(f) *Purchase price of the water and wastewater system.* The factors relevant to the reasonableness of the purchase price of the acquired water and wastewater system include:

- (1) Promotion of long-term viability.
- (2) Promotion of regionalization.
- (3) Usage per customer.
- (4) Growth rates.
- (5) Cost of improvements.
- (6) Age of the infrastructure.
- (7) Return on equity.
- (8) Existing rates.
- (9) Purchase price per customer.

Source

The provisions of this § 69.711 adopted March 29, 1996, effective March 30, 1996, 26 Pa.B. 1380; amended February 13, 1998, effective February 14, 1998, 28 Pa.B. 801; amended September 29, 2006, effective September 30, 2006, 36 Pa.B. 5991; corrected October 6, 2006, effective September 29, 2006, 36 Pa.B. 6107. Immediately preceding text appears at serial pages (255466) to (255468).

Cross References

This section cited in 52 Pa. Code § 69.721 (relating to water and wastewater acquisitions).

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WATER CONSUMER OFFICE

ATTACHMENT 4
Water Utility Risk and Return
California Public Utilities Commission
April 1990

RESPONSIBLE RESIDENTIAL UTILITY
WATER CONSUMER OFFICE

CALIFORNIA PUBLIC UTILITIES COMMISSION
Advisory and Compliance Division

WATER UTILITY RISK AND RETURN

San Francisco, California
April 1990

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

EXECUTIVE SUMMARY

Large water utilities and small water utilities have very different operating profiles. While both have high capital requirements and must comply with mandated water quality standards, small water companies have special problems created by their lack of economies of scale and inaccessibility to external financing. The number of economic dichotomies between large and small water utilities warrant separate analyses and, ultimately, different rate-making treatments. In general, traditional rate regulation is still appropriately applied to this industry, which has not experienced the fundamental market changes seen in energy and telecommunications.

Authorized returns on common equity have been lower for California water utilities than for California energy and telecommunications utilities. An analysis of large water utility financial reports indicates that California water utilities earn slightly lower returns on common equity than out-of-state water utilities, but their return on total capital is higher than either the energy, telecommunications or the out-of-state water utilities.

This is probably because large California water utilities are more effective in deriving revenues from ratebase assets than out-of-state water companies. California water companies also have high pre-tax coverage for interest expenses but their high operating ratios bring their profit margins below out-of-state water companies. It appears that California water companies may be earning lower returns for their shareholders due to the companies' relative inability to control operating expenses. The question also arises as to whether California water companies could use financial leverage to better advantage.

An analysis of small water company financial performance indicates no discernible pattern. The only common denominators are (1) their classification as "small" water, (2) their authorized rates of return and (3) their inability to earn authorized returns.

Analysis indicates that the sensitivity of a small water utility's earned rate of return is significantly greater than that of a large water utility. Small water utilities also face greater operating risk and such greater regulatory risks than large water utilities.

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Comparable Statistical Averages (1984-1988)

	<u>California Water Companies</u>	<u>Out-of-State Water Companies</u>
Return on Total Capital	11.38%	10.58%
Return on Common Equity	13.35%	13.60%
Long-Term Debt Ratio	40.84%	56.86%
Operating Revenue to Plant	69.92%	47.95%
Operating Ratio	83.53%	75.72%
Net Profit Margin	16.47%	24.29%
Pre-Tax Interest Coverage	4.71x	2.95x

RECOMMENDATION

There appears to be no compelling reason to change the current ratemaking mechanisms for large water companies. However, the Commission could consider holding en banc hearings or workshops to permit utility representatives to articulate their concerns and opinions. This would allow the utilities to address the positions taken by staff in this report and may bring additional issues to the Commission's attention. This would also allow California water utilities an opportunity to present their particular concerns regarding the threat of contamination of water supplies and the problems and costs associated with compliance with safe drinking water standards.

Current ratemaking practices for small water operations should be further investigated and refined in an Order Instituting Investigation (OII) on small water company rulemaking. In implementing a proceeding to address small water utility issues, the Commission is likely to encounter many of the problems that make the industry risky. For example, it is not clear that any of the owner-operators of small water companies would respond because they are unorganized, numerous and geographically dispersed. In addition, they lack the expertise and sophistication to advance their interest in regulatory proceedings and they are not active in water industry organizations, which generally concentrate on large water company issues.

Some options towards developing ratemaking principles that are more beneficial to small water company operators are listed in this report in Section V, "Regulatory Issues and Alternatives."

RESPONSIBLE RESIDENTIAL UTILITY WATER CONSUMER OFFICE

MEMORANDUM

This report was prepared by the Financial Branch and the Water Utilities Branch of the Commission Advisory and Compliance Division.

Phyllis White, Public Utilities Regulatory Program Specialist I was responsible for the preparation of this report, under the general supervision of Cherric Conner, Principal Financial Examiner, and with the assistance of Molly Oswald, Financial Examiner III, and Jix Hernandez, Public Utilities Regulatory Analyst II.

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RESPONSIBLE RESIDENTIAL UTILITY
WATER CONSUMER OFFICE

CALIFORNIA PUBLIC UTILITIES COMMISSION
Advisory and Compliance Division

WATER UTILITY RISK AND RETURN

San Francisco, California
April 1990

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WATER UTILITY RISK AND RETURN

I. INTRODUCTION

Many of the traditional ratemaking mechanisms used in water regulation were established during a period when all utility markets were monopolies. In recent years, however competitive pressures in energy and telecommunication utility markets have evolved as a result of federal legislative and regulatory actions and technological innovation. The Commission has revised its ratemaking mechanisms in response to these new utility market realities. In implementing new regulatory frameworks, the Commission has acted to maintain utility efficiency, productivity and financial strength, while ensuring that essential utility services will continue to be provided at reasonable rates.

The Commission continues to review regulatory policy and practices for all of the industries which it regulates. The following report is in response to the Commission's request for a rate of return and risk analysis of water utilities within its jurisdiction. Where refinement of water ratemaking policy and procedures is appropriate, the Commission may wish to further explore ratemaking options in an appropriate proceeding.

This report first reviews the properties, concerns and ratemaking treatment of large water utilities. It then addresses corresponding issues from the perspective of small water utilities. Some issues are common to both large and small utilities; however, as this paper will develop, large and small water companies represent very different types of systems. The number of economic dichotomies between large and small water utilities warrant separate analyses and, ultimately, different ratemaking treatment.

II. CLASSIFICATION

In Decision 85-04-076, the Commission approved the following Uniform System of Accounts subdivisions for water utilities.

Class A: Utilities having more than 10,000 service connections.

Class B: Utilities having between 2,000 and 10,000 service connections.

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Class C: Utilities having between 500 and 2,000 service connections.

Class D: Utilities having less than 500 service connections.

This classification, based upon service connections, is designed to reflect income tax regulations and the institution of the Safe Drinking Water Bond Act, as well as to reduce record keeping requirements for utilities.

For purposes of this paper, we define large water utilities to be Class A and small water utilities to be Classes B, C and D.

III. LARGE WATER UTILITIES

A. RISK OVERVIEW

Risk has to do with perceptions of uncertainty and variability. Utility risk can be divided into financial risk and operational risk. Financial risk is concerned with the possibility of bankruptcy and default due to the company's fixed debt obligations. The financial structure of the company to a great extent determines financial risk. Operational or business risk encompasses all of the factors which collectively increase the probability that expected earnings will not be realized or which contribute to earnings volatility.

There is higher perception of risk in energy and telephone operations as a result of new competitive pressures in those industries. New regulatory frameworks, implemented in response to new realities, tend to contribute to perceptions of risk because they generally remove earnings protections, while they permit significantly higher earnings opportunities. For overall economic efficiency, market mechanisms are preferred to regulation. Nonetheless, competition as a substitute for rate regulation translates into greater earnings volatility, which translates into greater business risk.

Some special areas of water utility operational and financial risk are discussed below:

(1) Technological Risk

Water companies are capital intensive and plant assets have long lives. Pipelines can last for 100 years or more. Treatment

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facilities, storage tanks and pumps range in life span from 30 to 50 years. Consequently, when facilities ultimately wear out, the cost of replacement in relationship to original cost can be quite enormous. Because obsolescence is not a problem, technological risk is small. However, technology-based productivity improvements are also rarer for water utilities than some of the other utilities.

Technology is improving at the customer level, however improved irrigation methods, low water-use fixtures (toilets, shower heads) and changing social standards are making conservation more acceptable and effective. This change in customer habits does not pose a direct risk to the utility, but it could present an indirect risk if these usage reductions are not recognized in the regulatory process.

(2) Financing Risk

New financings come from internal sources of funds--retained earnings, depreciation, deferred taxes and from external financing--advances and contributions from real estate developers, government subsidies and issuance of debt and equity securities. Where water utilities compete with other public and private entities for external financing capital, the stability of the water utility business should provide comfort to creditors and equity investors seeking attractive investment opportunities with relatively low risk. However the small size of water utility offerings, relative to other utilities tend not to generate interest among investment bankers. Consequently, most water utilities remain unknown except to a subset of the financial community such as insurance companies. Virtually all external financing is accomplished through private placement directly with investors, without use of an underwriter.

Advances and contributions will be discussed on page 13 in the context of small water company issues. California's program for financial assistance for water companies, the Safe Drinking Water Bond Act (SDWBA), will be discussed to some extent in the following water quality risk section and will be discussed more fully in the context of small water company issues on page 14.

(3) Market Risk

Although the fundamental market changes seen in energy and telecommunications industry markets are not evident in the water industry, water companies are not without competitive pressure. The primary source of competition for water utilities is the threat of customers drilling their own well. This risk has always

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existed but the industry persevered because of the economies of scale available to water suppliers. Nonetheless, industrial customers leaving the system may be a real possibility for large water companies. If a rate design includes provisions such as increasing block rates, the threat of customer bypass is likely.

Another form of competition cited by water companies is the potential of being condemned by local government and restructured into a local municipal water district. When a government entity exercises its right to eminent domain, just compensation must be paid for the taking as measured by the property's market value. Seldom are well constructed, well maintained and well managed public utilities sold at rate base. Frequently water utility plant and facilities sell over rate base due to the utility having relied heavily upon contributed capital rather than investor money for extensions.

(4) Water Quality Risk

Water quality has been a concern since 1974. The federal Safe Drinking Water Act (SDWA) of 1974 authorized the Environmental Protection Agency (EPA) to set national drinking water standards and provided for protection of ground water sources of drinking water. In response to the federal law, the California legislature enacted the Pure Drinking Water Act of 1976 and the Department of Health Services (DHS) established drinking water standards at least equal to EPA standards and required monitoring of community water supplies. Government mandated monitoring increases utility operating costs associated with water supply testing, liability insurance premiums and construction of water quality improvement projects.

The cost and rate impact of compliance with SDWA will vary with the size of the system and the complexity of the required treatment. California's Safe Drinking Water Bond Act (SDWBA) was created to be a source of low cost financing for water utilities that must make system improvements but cannot obtain financing elsewhere. As part of its review and funding process, DHS prioritizes utilities based on the need for repairs and the ability to finance the repairs. Most Class A water utilities have the financial strength to obtain external financing to make improvements to comply with DHS standards. Therefore, while Class A water utilities may request SDWBA funding for water quality improvements, they are unlikely to receive such funds.

Table 1 shows typical costs for certain types of tests. Depending upon the size of the system, the cost of testing and insurance may increase large water company rates 2-10 percent. Most Class A companies, with systems requiring a significant

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number of analyses, have found that it is economically feasible to perform the analysis in-house. Alternatively, a water utility may use a certified commercial laboratory or a combination of in-house and commercial facilities. Using an outside laboratory can be expensive. In a generic sense, the costs will be determined by the size of the system, the degree of the contaminated water, the number of samples required, who does the sampling and other costs that can be associated with individual utilities. Water testing costs may be booked to a balancing account and entirely recovered in rates. The balancing account mechanism is discussed on page 9.

The CACD believes that the issue of water quality is the most important and potentially the most costly issue facing the industry. Water utilities are just now beginning to experience those problems and costs. As water quality standards and testing procedures evolve over the next few years the industry and the Commission will have to explore policies and alternatives which best address the concerns of all.

B. ANALYSIS OF FINANCIAL PERFORMANCE

Evaluation of risk and return necessarily requires consideration of subjective, non-quantitative criteria, as well as objective, quantitative criteria. The following section is an analysis of selected financial criteria.

(1) Standard & Poor Bond Rating Benchmarks

Bond ratings are measures of the credit risk inherent in a particular debt issue. Few water utility bonds, however, are formally rated because most issues are relatively small and sold to institutions that do their own analyses. Nonetheless, Standard & Poor's (S&P) benchmarks for investment grade bonds can serve as independent market measures of utility financial integrity.

Table 2 illustrates S&P investment grade ratings benchmarks for large water, energy and telecommunication utilities. The investment grade distinction indicates a strong capacity to pay interest and principal. Not surprisingly, rating criteria differ among industries and within segments of the same industry. Companies with more protected financial and operating positions have less stringent benchmark criteria. The table demonstrates that S&P views water utility earnings to be at lower risk relative to other regulated industries.

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(2) Ratio Analysis

This analysis was developed from financial data of large California water companies (Class A) and a comparable group of other large water companies from all over the United States. Where applicable, corresponding indicators for California telecommunications and energy utilities are also shown. Sources for the data were annual reports to shareholders, annual reports to the CPUC and Value Line reports. Data tables and more complete interpretations appear in the back of this paper. The following is a synopsis of the findings that appear in Tables 3 through 14.

Authorized returns on common equity have been lower for California water companies than for other California utilities, however, the water utilities have tended to earn a higher percentage of their authorized than have the energy and telecommunication utilities. Authorized levels of earnings appear to be commensurate and appropriate for prevailing levels of inflation and interest rates.

California water utilities earned lower returns on common equity than out-of-state water companies in three of the last five years. One possible contributor to lower earnings available to common shareholders may be the tendency of California water companies to avoid using debt leverage (and the attendant tax deductibility of the cost of debt) to its optimal advantage because on average California water utilities have earned higher returns on total capital than have the other utilities in our sample.

California water utilities are very effective in deriving revenues from ratebase assets. The greater revenue generating capacity is particularly significant in light of their higher use of advances and contributions and lower plant to customer ratio. California large water companies, however, appear to have more difficulty controlling their operating expenses. As a result, net profit margins for California water companies are lower than for out-of-state water companies.

C. ANALYSIS OF OPERATIONAL PERFORMANCE

(1) Drought and Mandatory Rationing

The issue of financial recovery for lost revenues due to voluntary conservation or mandatory rationing is being addressed in Investigation 89-03-005. This OII is being kept open to address future water company concerns with drought, rationing and

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conservation impacts.

In this proceeding, the utilities are claiming that conservation and mandatory rationing decrease the companies' revenues. Commission staff agrees that the utility should be allowed to recover revenues that were not attainable due to actions that were out of the control of the utility. The disagreement is with the percentage of recoverable lost revenues. The utilities want 100% and Commission staff is recommending 95% of normal sales.

If the utility is allowed to recover 100% of their normal revenues they will be kept financially whole. Staff argues that this would guarantee revenues and eliminate any incentive to make prudent decisions in regards to expenses. Staff is maintaining that, if drought can be considered a risk that water utilities must confront and if the Commission guarantees revenues lost due to the drought, then the utility should be given a lower rate of return to reflect the lower risk. The return on equity should be reduced because investors will have a more assured opportunity to earn their authorized return than the investors in the comparison water companies on which the ROE computation was based.

If the Commission adopts Staff's recommendation of a 95% recovery of normal sales, the utilities will experience a reduction in their return on equity ranging between 5% to 25%. The reduction would depend on the proportion of revenues from water sales or service charges, the portion of water sales revenue paying for production expenses, and how much of a utility's revenue pays for fixed costs and non-tax expenses.^{1/} A 5% reduction in sales revenues would lower an authorized return on equity of 12% to an actual return of 9% to 11.4%.

(2) Voluntary Conservation

Conservation also provides an alternative to manipulating return on equity. If the Commission were to authorize the utilities to establish a revenue balancing account, similar to the ERAM account for electric companies, then utilities' conservation incentives would increase and their operating risk would substantially decrease. Return on equity should be investigated at the

^{1/} A utility that has about 40% of its revenues from service charges, with relatively high water production expenses and about 61% fixed expenses would see about a 6% decrease on equity. A utility with 20% of its revenues from service charges, lower production expenses and 80% fixed expenses could suffer a 25% decrease in return.

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same time that the revenue balancing account is addressed to determine any impact on risk perception.

(3) Comparison of Water Rates

Table 15 shows a rate comparison, by Class size (A, B, C, and D), of the monthly rates of the regulated and the unregulated water utilities. The table shows that unregulated companies provide water at a lower average cost per month and at a lower consumption per month than regulated companies. For example, the customer of a Class A water utility pays rates that average \$28.97 a month, while using an average of 32.45 ccf/mo. The customer of an unregulated company of a Class A size pays rates averaging \$16.95/mo. with a consumption of approximately 26.98 ccf per month. This translates into customers of regulated utilities paying rates approximately 74% more per month while consuming approximately 20% more ccfs of water per month than customers of unregulated water companies.

The customers of the Class B, C and D utilities do not fare any better. The customers of a regulated utility have an average bill of \$20.74/mo. with an average consumption of 17.07 ccf/mo., while their unregulated counterparts pay rates on the average of \$14.30 per month for an average consumption of 18.86 ccf a month. The customers of the small regulated water utilities are paying 145% more a month for their water while consuming 9.5% ccfs a month less than the unregulated water companies.

The classic explanation for the unregulated water utilities having an average lower monthly rate is three-fold. Municipal utilities do not pay taxes; they charge substantial hook-up fees and, as public entities, they are able to issue tax exempt municipal bonds to finance new plant.

D. CURRENT RATEMAKING PRACTICES

At the Commission, water utilities have access to the same forums for rate relief as do energy and telecommunications utilities. Many aspects of water costs of service are reviewed only during formal general rate case proceedings which occur in three year cycles, although water companies are allowed to offset minor operating costs through informal advice letters and there is no restriction on how often advice letters may be filed. Energy utilities are also permitted to offset certain fuel costs but these proceedings are for the most part limited to once a year. In addition, the capital costs of energy and mid-size telecommunications utilities are reviewed annually in industry generic

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financial attrition proceedings.

(1) Rates of Return

For single-district companies, return on common equity is fixed for the test period and remains constant until the company refiles. For water utilities with multi-district operations, returns authorized in any particular general rate case will be applicable only for those districts filing. In succeeding years, attrition adjustments are made to reflect the rate of return found reasonable for the district in its last decision or that found reasonable for other districts in the company's most recent rate decision.

When authorized returns are increasing single district water companies are somewhat at a disadvantage relative to multi-district water companies. Conversely, they have an advantage when authorized returns are declining. When authorized rates of return are increasing, some portion of a multi-district water company ratebase will continue to earn at lower return levels. Relative to single district energy and telephone companies, multi-district water companies are at an advantage when authorized rates are decreasing because at least some of their rate base will remain eligible for higher returns.

(2) Balancing Accounts

The purpose of a balancing account is to track the under-collection or over-collection associated with an increase or decrease of an expense item and the authorization of a corresponding revenue adjustment by the Commission to offset that particular expense charge.

Pursuant to Section 792.5 of the California Public Utilities Code, whenever the Commission authorizes any change in rates reflecting and passing through to customers specific changes in costs, a balancing account is to be maintained for that particular expense item. These types of expense items are called offsetable expenses and relate to costs over which the utility has no control. Among offsetable expenses which require balancing accounts to be maintained are:

1. Purchase power expense
2. Purchased water expense
3. Pump Taxes
4. Franchise Taxes
5. Property Taxes
6. Postage

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These balancing accounts enable a utility to recoup the additional expenditures which may occur due to the lag between the time an offsetable expense change takes place and the time when the revenue increase to offset the expense change is authorized. Prior to the balancing account requirement in the Code, utilities were not able to recover the additional expenses due to the time lag between expense change and revenue offset.

Balancing accounts simplify the rate making process. Because balancing accounts recover potential losses during the lag time between expense increase and offset revenue increase (see below), a utility no longer has to file for an offset increase every time there's an increase in an offsetable expense. The balancing account accumulates over/under-collection until such time that the utility is ready to file for an offset.

A properly maintained balancing account eliminates a utility's risk of not being able to recover increases in expenses over which it has no control.

(3) Offset Filings

Similar to other utilities, water utilities may offset unanticipated operating expenses at any time during the year through an informal advice letter filing. With the notable exception of general rate requests from small water utilities, neither ROR nor ROE is examined or adjusted in conjunction with advice letter filings. When water utilities process an offset request, the increase must be, at least, one percent of annual revenue. When an offset is approved, water utility balancing accounts are generally amortized over a one year period. Although the dollar amounts of water utility revenue under-collections are insignificant relative to energy utilities, the result is that water utility owners must cover under-collections more often than energy utility stockholders. One point of note is that many of the energy balancing account mechanisms are currently being considered for elimination in light of the evolving industry dynamics.

(4) Construction Work In Progress

Unlike for energy and telecommunications utilities, the CPUC does not have certification authority over water plant additions. For water utilities, a Certificate of Public Convenience and Necessity (CPC&N) is issued only for service territory expansions. The Commission staff reviews utility plant addition for reasonableness, however, and only allows reasonable amounts for

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plant additions to be included in rates.

Water projects with significant construction periods fall into five major categories: (1) miscellaneous structures, (2) tanks and reservoirs (3) transmission and distribution mains (4) treatment and (5) wells. Transmission and distribution mains represent the largest on-going construction projects. Treatment facilities are usually major projects but are infrequently constructed and as a result the dollar impact in any given year is minimal. The average construction time by categories are:

<u>Category</u>	<u>Construction Time</u> (Month)
Treatment Facilities	8.3
Tanks and Reservoirs	6.2
Transmission and Distribution Mains	3.9
Miscellaneous Structures	3.1
Wells	2.5

The average construction period for water projects is four months. This is a considerably shorter period than is experienced by energy utilities. Because of the short duration of construction time of projects, the Commission, on May 11, 1982, on recommendation by the staff, established the policy of including Construction Work in Progress (CWIP) in rate base for water utilities. However, this policy for water utilities did not lead the Commission to endorse a similar policy for energy and telecommunication utilities--where construction time often exceeds one year and where Allowances for Funds Used During Construction (AFUDC) for long term construction projects are allowed to accumulate.

Normally, a water utility's plans for constructing new facilities are reviewed in the General Rate Case. The utility is allowed to book CWIP on the basis of that review. For example, if it is determined that the utility will be spending \$100,000 per year average on new facilities, the utility will be allowed to book \$100,000 at the end of each year. Return on this investment is provided in the rate changes made for the following year. Once a project is complete it moves into Plant in Service, so Plant in Service is also reviewed in the CRC and allowed prospectively.

Sometimes a utility doesn't have a firm plan for adding a new facility, or has shown that in the past it has added facilities in a slow or erratic manner. In this case the Commission has required the utility to file for a rate base offset once the facility is placed into service.

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IV. SMALL WATER COMPANIES

A. RISK OVERVIEW

There are approximately 190 small investor owned water utilities in California. The majority are sole proprietorships, with the remainder being family-owned corporations and partnerships. Their risks essentially parallel those of larger water utilities, but their exposure is greater. Small system problems can be generally characterized as insufficient infrastructure, too few resources, stagnant or declining customer growth and little or no capital. The costs associated with water contamination can be handled by a large company but can be a serious financial problem to a smaller water company due to poor economies of scale. The situation is sometimes exacerbated by a lack of business sophistication and understanding of regulatory procedures.

Many small water utilities have little or no contact with the Commission until they experience major fiscal or operational difficulties. To assess the status of small water utilities under Commission regulation, the Water Branch, in 1987 and 1988, surveyed a sample of small water companies. One of the interesting findings was that of the utilities surveyed, one half needed large plant improvements such as wells, water storage tanks, hydrants, chlorinators or other equipment. Although none were found to be on the verge of collapse, many might be in that position if they continue to operate as is. Other observations were:

- (1) A small utility may operate at a loss or a break even point until a large plant improvement is needed. At that time, a small utility with less than 150 connections will not be able to spend a large amount of money on a plant improvement. The utility will continue to have a problem until money is found for plant improvement.
- (2) Owners do not want to operate sub-standard utilities. Of the systems for which the owners wanted to sell or give away, none had water quality that was above standard and 65% were below standard.
- (3) Many owners did not understand the advice letter filing process. Of the utilities surveyed, 26% had not filed for a rate increase because the owners felt it was too much trouble.

As a result of the survey, the Water Utilities Branch has implemented an outreach program to small water utility managers

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to instruct those that want to stay in the water business how to apply for informal rate increases and how to apply for Safe Drinking Water Bond Act loans.

(1) Financing Risk

Small water companies use advances and contributions more often than other utilities to fund construction of new facilities. This form of external financing is typically derived from real estate developers who deposit with the utility in advance of construction the estimated cost to build water facilities needed to serve the area to be developed. By contractual agreement, the utility will refund the advanced deposit over time based on either a multiple of revenues or cost per foot of pipe. Contribution deposits are not subject to refund.

Advances and contributions spread out the utility's funding requirements for growth and development in the service territory. These sources of funds are not included in utility rate of return calculations because these sources of capital are not provided by company investors. Nonetheless, operational risks increase as the percentage of contributions increase for the utility. For example, assuming a 10% return on ratebase, a utility with \$100,000 in plant, of which 40% is contributed, can only generate a return on investment of \$6,000. If the utility had used debt and equity capital, it would be able to earn \$10,000. The operational risk is highlighted when revenues change due to voluntary conservation and/or mandatory rationing.

The Tax Reform Act of 1986 (TRA-86) now requires that advances and contributions be treated as taxable income rather than contributions to capital. As a result, utilities are required to pay federal taxes on the amount of advances and contributions received. This tax treatment will likely reduce the appeal of these sources of funds. In Decision 87-09-026, the Commission authorized methods by which utilities may recover the federal taxes paid pursuant to TRA-86.

The Commission has ordered an investigation into the use of connection fees to help to mitigate the financial problems stemming from small water utilities inability to borrow money. If allowed, this change would put the regulated utilities on a more even footing with the unregulated municipal utilities, and might make them more viable.

(2) Market Risk

Some small water systems were not financially viable even

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when they were started. Inexperienced persons or speculators sometimes acquire a system believing they can improve it with little capital and sell at huge profits. Additionally, there may be non-financial rewards such as experimentation by a retiree with small business or by the buyers having a new role in the community. If the system is in poor physical condition and service is inadequate, thereby requiring extensive maintenance and/or capital improvements from the beginning, new owners are sometimes unwilling and often unable to respond, allowing service to deteriorate further. Problems like these may go on for years.

If angry customers are sufficiently organized, they may form a district or petition a local political subdivision to acquire the utility. If customers are insufficiently organized to accomplish a buy-out but complain to the Commission, the Commission may enter into extensive litigation in order to persuade the owner to effectively manage the system or to divest ownership. This strategy may have no effect or owners may make minimal improvements to avoid hearings and to justify capital-related rate increases. In extreme cases, owners have abandoned their systems.

Where the Commission will still have the responsibility of regulation after a sale, i.e. sales to individuals versus sales to public entities, current policy is to discourage formation of unviable or marginal water utilities. The burden is placed on buyers to prove the financial soundness of the proposed acquisitions, especially when buying above book cost. However, a purchase price above the system's depreciated historical cost does not inherently mean the price is imprudent.

(3) Water Quality Risk

The standards that apply to Class A utilities also apply to the Class B, C and D utilities. The real difference between the Class A utilities and the others is that there is a great limitation in the amounts of capital that small utilities can raise. To alleviate the financial burden, the Safe Drinking Water Bond Acts (SDWBA) of 1976, 1984, 1986, and 1988 were approved in the various state general elections.

The legislative intent of the SDWBA was to assure that all domestic water supplies meet minimum standards established under California's Health and Safety Code. The SDWBA directed that three state agencies--the Department of Health Services (DHS), Department of Water Resources (DWR), and the CPUC--share the administration of the program for investor-owned water utilities.

DHS is charged with the responsibility to recommend improve-

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nents and rehabilitation necessary to provide pure, wholesome, and potable water available in adequate quantity or sufficient pressure for health, cleanliness and other domestic purposes.

DWR is the banker for the SDWBA program. Upon receipt of the approved project plans and new permit from DHS, a detailed financial analysis is made to determine that the loan would be adequately received and the water utility has the ability to repay the loan. Those utilities which meet DWR's financial requirements are issued loan authorizations. Actual loans are made to a utility after (1) the CPUC approves the DWR loan contract and authorizes sufficient rates to repay the loan and (2) DHS approves the final SDWBA project plans and specifications.

To obtain CPUC approval to borrow the SDWBA funds and increase rates to repay the loan, the water utility must file an application with the CPUC. To provide the water utility's ratepayers with complete information on the SDWBA project, the CPUC conducts a public meeting or evidentiary hearing in the water utility service area. The Commission looks at the basic health requirements and deficiencies, the required plant improvements, size of the rate increase and the opinions of the ratepayers. The Commission decision is final.

In the fall of 1988, DWR mailed letters to all holders of loan contracts under the SDWBA of 1976 notifying them that the SDWBA of 1988 authorized the State to fix the interest rate at 8.1%. A number of the larger municipal loan holders, upon receipt of this letter, contacted the Director of DWR and requested that the 1976 program be treated the same as the 1984, 1985, and 1988 programs which allow the loan holders to pay only one half of the interest rate paid by the State of California for the bonds which finance the SDWBA program. It is anticipated that in a proposed 1990 SDWBA, a provision will be included to set the final rate of interest for the 1976 program at one-half the actual cost.

B. ANALYSIS OF FINANCIAL AND OPERATIONAL PERFORMANCE

(1) Financial Analysis

This analysis is a snapshot of the financial position of the California small water utilities. The criteria was to select small water utilities that received approval for general rate increases by resolution in 1988 and 1989. This sample of fourteen water utilities was analyzed by investigating certain financial indicators calculated from their 1988 annual reports to the CPUC (Table 16).

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The common ground shared by the small water companies is their comparable authorized rate of return and their inability to earn it. Ten companies out of the fourteen sampled earned a negative rate of return. Other than these items, staff found that the small water utilities have no other financial similarities.

The average capital structure for this sample of small water companies approximates that of the large water utilities--40% long-term debt and 60% common equity. However, six of the utilities were over 90% equity financed and at the other extreme, two had negative common equity due to accumulated operating losses which were greater than accumulated equity investment.

A widely held belief is that small water companies rely heavily upon advances and contributions. This analysis showed that there is a wide range to the levels of advances and contributions held by the small water utilities. For example there were only three companies with a ratio higher than the 15% average. The rest had ratios below the average. Five companies don't have any advances and contributions. Interestingly, there may be a correlation between the use of contributed capital and the capital intensity of a system. For example, Benbow Water, the most capital intensive company with \$2,282 invested per customer, has one of the lowest contributed plant ratio, 3.10%, but Elk Grove Water, the least capital intensive company with \$193 invested per customer, has the highest percentage of contributed plant, 62.12%.

This sample does not support the belief that utility revenues decrease with higher levels of contributed capital. The four companies with revenue to net plant investment ratios greater than the average also hold more contributed capital than the average. There is, however, no discernible correlation between contributed capital and ratebase earnings. Benbow Water earned 2.19% on ratebase in 1988 while Elk Grove earned 8.51% but Armstrong Valley earned the highest return, 15.75% with only 1.19% contributed capital and \$1,413 invested per customer. The company with the greatest losses, Los Guilicos at -50.31%, had zero contributed capital and \$1,011 invested per customer.

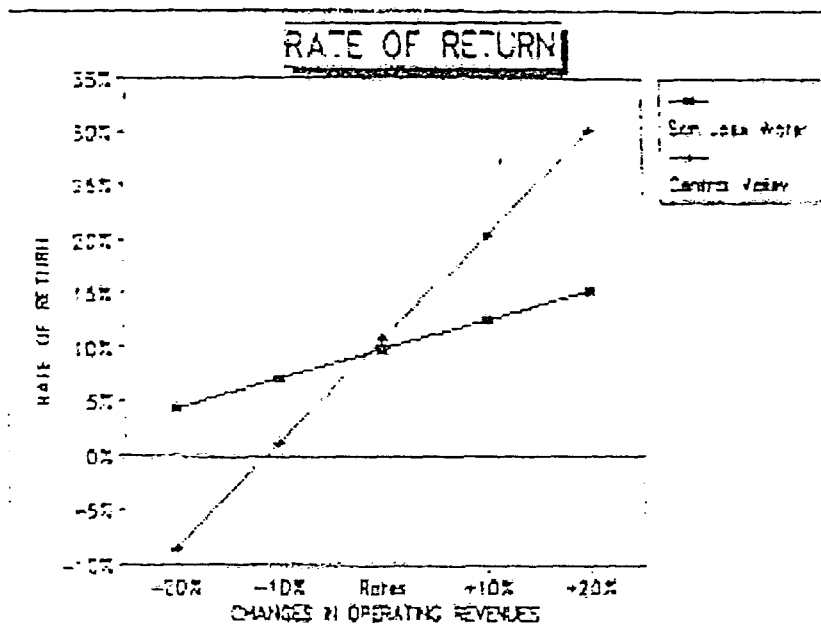
A factor contributing to small water utility operating risk is their very high operating expenses to operating revenue ratio. All of the companies in the sample had extremely high operating ratios, ranging from 64.76% to 230.94% and averaging 117.61%. Eleven of the fourteen companies had operating ratios above 90%. Not surprising, net profit margins are slim, ranging from 35.24% to -130.94%. Ten of the fourteen companies in this sample had net profit margins of 10% or below.

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A basic regulatory goal is to establish rates that are reasonable to ratepayers and that allow utilities the opportunity to earn their authorized returns. It is extremely difficult to obtain that goal for small water utilities.

(2) Operational Analysis

The large and small water utilities differ greatly with respect to changes in sales and revenues. The following chart shows that large water utility rates of return (ROR) are less sensitive to changes in revenue than are small water companies. In this example, changing the expected revenues of a Class A water utility (San Jose Water Company) $\pm 10\%$ varies the rate of return $\pm 27\%$. If revenues of a Class D water company (Central Valley Water Company) are changed by 10% the rate of return will change $\pm 112\%$.



Two actions could be taken to compensate the small water companies for the high financial risk that they face. One method considered is to authorize a larger ROR, but this increase just shifts the operating line upward without reducing the level of risk.

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An alternative method would be to grant a "management fee", to the small water companies, which would not be tied to the ratebase, but tied to some other criteria. The effect would tilt the ROR line so that it would resemble the ROR line of the large water utilities (Management fees are discussed on page 21), that is, the operational risk facing the small water utilities would be compensated.

C. CURRENT RATEMAKING PRACTICES

Typically Class B, C and D water utilities are permitted to file advice letter requests for timely rate relief without need of a formal hearing. This method eliminates the high cost of a rate case proceeding. In establishing revenue requirements, current practice is to perform individual company analyses of operating costs and to authorize ROR from within a standard narrow range. To a large extent, small water utilities are funded solely with equity capital. In the case of 100% equity financed companies, the ROR is the ROE.

The current standard ROR for 100% equity financed small water utilities, 10.75% plus or minus .25%, has been in effect since April 20, 1989. The method for deriving the standard range is rather subjective, with periodic revisions made in response to changes in prevailing interest rates, inflation and general economic conditions. There is no standard basis point spread, but consideration is given to recent returns authorized for the larger Class A, mixed capitalized, water utilities. The range of authorized returns provides a degree of flexibility in setting revenue requirements to allow for perceived differences in water quality, service, management, etc. while still providing a reasonable return to owners. The existence of extraordinary circumstances would dictate a ROR different from the standard rate.

For small water companies with net taxable income of less than \$75,000, ratemaking income tax allowances are based on effective tax rates of 15% of the first \$50,000 and 25% of the next \$25,000 compared to 34% for large Class A water companies. These lower tax rates translate into lower net-to-gross multipliers ranging from 1.3 to 1.7 as opposed to the 1.7 multiplier for Class A companies. These tax rate differentials mitigate the higher revenue requirements usually associated with utilities holding high amounts of equity capital. Table 17 shows the pretax weighted cost of capital for four of the largest Class A companies compared to the range available to small water companies.

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V. REGULATORY ISSUES AND ALTERNATIVES

A. RECLASSIFICATION

Current classifications subdivide the utilities by the number of service connections, the utilities, for the most part, are still regulated by the traditional regulatory approach (ratebase regulation). This form of regulation on the small water utilities (Classes B, C and D) seem to exacerbate the problem. A reclassification of the water utilities could be designed in a way that allows the Commission to identify the unique economic problems faced by the utilities within a given class.

For example the root of the problem to small water utilities is economic in nature. Small water utilities provide water at higher per unit costs than large utilities. Large water utilities are able to provide professional management and lower cost service because they spread the fixed costs of operations over more customers. Because of the size and the nature of operations, it is often difficult for normal regulatory tools to provide the intended protection for both consumers and the small water utilities serving them.

To alleviate many of the problems that are faced by the small water utilities a new approach could be developed in classification and regulation. One method is classification of the water utilities based on the percentage of contributions. When a water utility has a large percentage of contributions in their capital base, operational risk increases for the utility.

B. LARGE WATER RATEMAKING ALTERNATIVES

Large water companies are capital intensive operations that exhibit increasing returns to scale and enjoy well defined service territories, in which they are sole suppliers to a captive customer market with few substitutes. Bypass (an industrial customer drilling a well) could occur due to uneconomic distortion created by inappropriate rate design. Frequent rate cases and balancing account treatment of uncontrollable operating expenses, insulate utility shareholders from extreme financial and operating risks. Public utility regulation was designed for monopoly industries such as large investor owned water companies.

The ratemaking procedures currently employed by the Commission--oversight of utility capital budgets, imputing productivity incentives and controlling costs of service--continue to be appropriate for this sector of the water utility industry. There

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appears to be no compelling reason to change. However, the Commission could consider permitting utility representatives to articulate their concerns in a workshop listing options and alternatives to current regulation procedures.

C. SMALL WATER RATEMAKING ALTERNATIVES

(1) Mergers and Acquisitions

A possible solution to the myriad of problems besetting small water utilities is to more actively promote Commission Resolution No. M-4708 dated August 28, 1978 that supports conversion of unviable or marginal water utilities to public ownership or their mergers with more viable water operations. The practicality and viability of such takeovers could be explored in detail in an Order Instituting Investigation (OII). Issues that should be investigated would include:

- o What incentives exist for larger companies or municipalities to takeover the small companies.
- o Should the Commission encourage such takeovers by creating sufficient incentives.
- o What would be the likely impact on rates of both the acquiring company and the company acquired.
- o What practical problems should be considered, i.e. physical location and characteristics, viability of interconnecting systems.
- o What are the possibilities of large water utilities obtaining low cost SDWA funds for upgrading any small systems they may takeover.

(2) Financing Assistance

The problem of small water utilities is fundamentally due to insufficient economies of scale and not just insufficient access to financing. For that reason, the Commission as well as many other regulatory jurisdictions around the country have granted small water companies lower equity returns than larger companies. Nonetheless, small water utilities are clearly more risky than large water utilities and theory would support the notion that the required return on investment should be higher for small water than for large water companies.

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The following are options towards improving the financial viability and flexibility of small water utilities.

SUBSIDIZATION

A fund could be created for the purpose of lending money to small water companies, at reasonable rates and over a long enough repayment period to reduce rate shock. The program could be subsidized by general surcharge revenues or general obligation bonds, permitting loans at very low or no interest rates.

ATTRIBUTE A CARRYING COST TO PROPRIETARY CAPITAL

When a company owner lends funds to the company which it would be unable to secure on its own, or guarantees a loan on the company's behalf, the Commission could allow some premium above the cost of the loan to compensate for the risk and the potential that the money could have been invested in a venture that is more profitable.

MANAGEMENT SALARIES AND FEES

To attract qualified management and to maintain management's interest in the water system, salary compensation could be set on an individual basis rather than on a range of salaries. In addition to salaries, a management fee could be considered.

Water utilities, large and small, are allowed to expense management salaries. The Class A utilities and some of the Class B utilities find little financial constraint in negotiating the amount that the Commission will approve, besides, these Classes possess such financial strength that management salaries have a small effect on their rate of return. It is the smaller Classes, C and D, where management salaries play a larger importance on the company's rate of return. The current process for setting management salaries is to project the expense. The Commission's staff then evaluates the amount by comparing it to other utilities of similar size and geography. What could be considered is the individual merits of the company and its management. For example, a water utility whose owner/operator possesses a Professional Engineers License, or a Plumbing License or any License that allows the owner/operator to perform the work rather than having to contract the work out, could be allowed a salary that reflects the expertise and commitment to the utility.

Although Class A water utilities serve the same function as the Class B, C and D, they should be regulated differently with

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the issue of management salaries. Management fees could be granted to the Class B, C and D water utilities. Although there is an argument that Class B, C and D water utilities require less work than large utilities, an incentive is needed for the owner/operators of the small classes, especially Class D. In the Class D utilities many are financially strapped and find it difficult to find additional lending and/or additional investors. Many resort to using their homes and/or personal property as collateral. A financial incentive, such as a management fee, would give reason to remain with the system rather than to abandon it.

AUTHORIZE HIGHER RETURNS ON INVESTMENT

Current authorized returns may not fully reflect the risks inherent in small water company operations because the current methodology for small water companies concentrates heavily on their relative absence of financial risk (many are funded solely with equity capital.) There is no recognition of the relatively large operating expenses and high earnings volatility associated with small water operations.

Establishing the generic ROR range for 100% equity water companies is quite subjective. However, attempting more precision or a strict quantification of a risk premium for operating risk could be even more problematic. As risk inherent in small water company operations are not comparable to any water company for which market data is available, results of the other financial models would also be difficult to interpret. Nonetheless, the Commission has the authority to authorize any rate of return within the range of fairness and reasonableness. In affirmation of its support of small water company investors, the Commission may adopt a policy of authorizing a number of percentage points above large water authorizations (for example) to determine the small water ROR.

(2) Rate Relief

The current process in California for setting rates for the small utilities is through the advice letter filing process. This method eliminates the high cost of a rate case proceeding, while protecting the rights of both the consumer and the utility to participate in the process.

Alternatives that could be considered in setting rates are as follows:

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INDEXING

For whatever reason, many small utilities do not come in for needed rate increases. Allowing automatic rate adjustments which could be set to an index would allow the utility to recover those expenses that are out of the control of the utility. Therefore, the recovery of lost or gained revenues are not adjusted when the utility saves or wastes money and the stockholders will bear these gains or costs. Indexing will also preserve the incentives found with test year ratemaking.

The Commission can either construct a new index for the water industry or use an existing one, but one that does not contain variables that are controllable by the utility. If the utility is allowed to have some control over the variable then the index may serve as a pass through mechanism. For example, the index may cover expenses brought on by drought conditions, such as mandatory rationing.

REFEREE

A Commission approved referee could be designated by the Commission with the role of settling disputes over expenses between the Commission staff and the utility. Many of the smaller water utilities would find this advantageous. For example, smaller water utilities do not have the resources to file for a formal rate case hearing to dispute the expenses that Commission staff is disapproving.

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VI. INDEX OF TABLES

The following tables illustrate several topics discussed in the text. For the most part, they compare the performance of California water companies with that of various other public and private companies. The companies used in these analyses are listed in Tables 18 and 19.

<u>Table</u>	<u>Subject</u>
1	Water Quality Testing & Associated Costs
2	Standard & Poor's Rating Benchmark Definitions
3	California Water, Energy and Telecommunications Companies, Allowed vs. Earned Return on Equity
4	California Class A Water Utilities vs. A-Rated Bonds, Allowed and Earned Returns, Yields, and Spreads
5	Actual Return on Total Capital
6	Actual Return on Common Equity
7	Actual Long-Term Debt Ratio
8	Actual Common Equity Ratio
9	Pre-Tax Interest Coverage
10	Revenue to Net Plant Investment
11	Advances & Contributions to Net Utility Plant
12	Net Plant Investment per Customer
13	Operating Ratio
14	Net Profit Margin
15	Rate Comparisons of California Regulated and Unregulated Water Utilities
16	Sample of Small Water Companies Financial Statistics
17	Pre-Tax Weighted Cost of Capital
18	List of Companies Used in the Data Tables
19	List of Companies Used for Rate & Usage Comparisons

ATTACHMENT G

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Greg Barber (a-d)
Title: Controller – EPCOR Water (USA) Inc.
Sarah Mahler (e-f)
Rates Manager - EPCOR Water (USA) Inc.

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: RUCO 5.01

Q: Net Present Value ("NPV") Analysis – This is a follow-up to RUCO data request 4.04. In which RUCO asked the following:

Did EPCOR do any NPV Analysis or revenue/cash stream projections when it purchased Willow Valley? If no analysis was prepared please explain why not?

The Company responded:

Yes, we did a NPV Analysis for the Willow Valley acquisition. However, the purchase price was the result of arms-length negotiation between the buyer and seller and represents the lowest acquisition price that the current owner would accept to sell the Willow Valley systems. This negotiated acquisition price was the result of protected negotiations with the seller who initially indicated an expectation of a higher acquisition price. The NPV analysis performed by EPCOR simply supported that negotiated price.

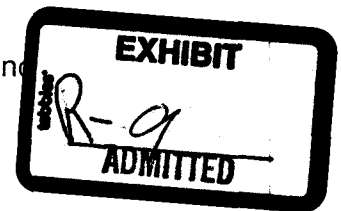
Based on the Company's response please answer the following questions:

- a. Please provide a copy of this NPV analysis, in excel format with formula intact.
- b. Please provide the name of the employee(s) who conducted this NPV analysis.
- c. The date the NPV analysis done.
- d. Did the rates department conduct this NPV Analysis? If no what department conducted the NPV Analysis.
- e. When RUCO Staff, Mr. Michlik and Mr. Mease, met with Company representatives Sheryl Hubbard, Sarah Mahler and Alex Lovisetto, on August 28, 2015, RUCO was told that the Company had not prepared a NPV analysis. Since then, RUCO has been told by the Company that it has done a NPV analysis. (See response above) Please explain the inconsistencies in the information provided to RUCO.
- f. Please explain, to the extent it has not been explained, in the Company's response to e. above, why RUCO was not provided with a NPV analysis when originally asked on August 28, 2015.

A:

- a. EWAZ objects to DR RUCO 5.01(a) to the extent that it is not relevant to the Commission's determination of the present action and is not reasonably calculated to lead to the discovery of admissible evidence. The agreed purchase price was the result of arms-length negotiations and not a result of a financial model. Moreover, EWAZ's NPV analysis has no relevance on whether or not the proposed acquisition is in the public interest as EWAZ has committed to abide by the rates established by the Commission in Willow Valley's most recent rate case. EWAZ further objects to DR RUCO 5.01(a) to the extent that the information requested is highly confidential business information or trade secrets. Disclosure of the information requested by RUCO, even pursuant to a protective agreement, would adversely impact EWAZ's future operations and the Commission's stated policy of encouraging the consolidation of private utilities.
- b. The financial analysis was conducted by the Finance group under the supervision of Greg Barber.
- c. The financial analysis was completed in October 2014.
- d. The Rates Department did not conduct the financial analysis. See also response to b. above.
- e. The named employees stated they were not the people who had conducted the financial analysis and that any questions relating to the financial analysis would be better addressed through a formal data request.
- f. See e above.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131



Response provided by: Sarah Mahler
Title: Rate Manager, EWAZ

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: STF GWB 1.7

Page 1 of 2

***For all data requests for which you do not have the information requested, please state such and skip to the next data request. Also, for responses to data requests that may be voluminous or overly burdensome, please contact the assigned analyst, Gerald W. Becker, at 602-542-0831 to discuss.

Q: Rate of Return - please provide a schedule showing the rate of return along with all components as approved in Decision No. 74364 and a schedule showing EPCOR's proposed cost of capital in its most recent case in Docket No. WS-01303A-14-0010.

- a. Please explain the capital structure that would result if the proposed transfer to EPCOR.
- b. Please provide schedules to support the capital structure that would result if the proposed transfer to EPCOR.
- c. Please quantify any change to Willow Valley's pro forma revenue requirement if the proposed capital structure were to be applied in Willow Valley's most recent rate case.
- d. Please indicate whether any reduction to revenue requirements as a result of a revised capital structure is appropriately shared with Willow Valley's ratepayers and provide explanations to support the position. Please provide any workpapers necessary to support changes to revenue requirements.

A:

a. EWAZ objects to DR GWB 1.7 to the extent that it is not reasonably calculated to lead to the discovery of admissible evidence. EPCOR also objects to DR GWB 1.7 to the extent that it is vague and ambiguous and calls for speculation. EPCOR further objects to DR GWB 1.7 as unnecessarily burdensome in that it seeks information that is readily available to Staff in the identified Decision and Docket. Without waiver of the foregoing general and specific objections, and as an accommodation to Staff, EWAZ states its proposed cost of capital in Docket No. WS-01303A-14-0010 is referenced in the table below. EPCOR further notes, as stated in the Application, that at this time EPCOR does not anticipate changing any of the elements established in Decision No. 74364 following the acquisition. As a result, speculation as to potential changes to capital structure prior to Willow Valley's next rate case is premature. EWAZ will address capital structure issues in Willow Valley's next required rate case.

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: W-01732A-15-0131

Response provided by: Sarah Mahler
Title: Rate Manager, EWAZ

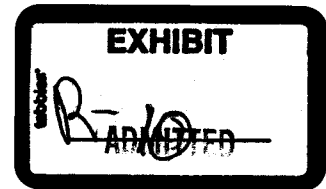
Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Company Response Number: STF GWB 1.7

Page 2 of 2

EPCOR Docket No WS-01303A-14-0010			
	Percent of Total	Cost Rate	Weighted Cost
Debt	59.76%	4.29%	2.56%
Equity	40.24%	10.55%	4.25%
	100.00%		6.81%

- b. Please refer to EWAZ's response to item a. above.
- c. Please refer to EWAZ's response to item a. above.
- d. Please refer to EWAZ's response to item a. above.



COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

EPCOR Response provided by: Sarah Mahler
Title: Rate Manager

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Global Response provided by: Ron Fleming
Title: CEO

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 6.03

Page 1 of 2

- Q. Benefits to Existing Customers – On page 4, line 4, of Mr. Bradford's rebuttal testimony he states that he has developed a plan to drop water loss from 26 percent to 1 percent within the first five years. Please answer the following:
- a. Does Global Water believe Mr. Bradford's plan is possible? If no please explain.
 - b. Does Global Water believe it can reduce water loss by 25 percent in the first five years?
 - c. If yes to b., why hasn't Global Water reduced the water loss by 25 percent already?
 - d. Please provide the percentage of water loss by year since Global Water took over operations of the Willow Valley System.
- A. EPCOR: Mr. Bradford's testimony stated EPCOR will "reduce non-revenue water by 25% within the first 5 years of ownership." To clarify the meaning of this phrase; EPCOR has asserted it will reduce water loss by one quarter (25%) of the current level, or 6.5% of the current 26.1%. Mathematically represented: $[26.1 * 25\%] = 6.5\%$. The Company is proposing a plan to reduce water loss by 6.5%, to approximately 19.6% in year 5.

GLOBAL: (Parts A to C) Please see clarification above regarding Mr. Bradford's testimony. Regarding whether the plan is possible, please see response to RUCO 6.02. It is worth noting, which Global Water did through several rate cases including the approval of the SIB itself, that Global Water put a comprehensive water loss program in place for Willow Valley. In short, we replaced all meters, installed advanced meter reading systems, implemented billing analysis and protocols to ensure validity of usage data, etc. Despite these efforts, water loss

COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

EPCOR Response provided by: Sarah Mahler
Title: Rate Manager

Address: 2355 W. Pinnacle Peak Road, Suite 300
Phoenix, AZ 85027

Global Response provided by: Ron Fleming
Title: CEO

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 6.03

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has continued to accelerate because the primary driver is the failing pipeline system, which can only be corrected by the removal and replacement of the waterlines.

(Part D). Regarding Item d. Global Water acquired Willow Valley mid-year on July 1, 2006. The following shows historical water loss for each calendar year beginning in 2007.

Year	2007	2008	2009	2010	2011	2012	2013	2014
Water Loss	11%	17.4%	16.5%	19.5%	23.5%	23.1%	22.3%	27.8%



COMPANY: EPCOR Water Arizona Inc. and Willow Valley Water Co., Inc.
DOCKET NO: WS-01303A-15-0131 and W-01732A-15-0131

Response provided by: Ron Fleming, Global Water Resources, Inc.
Title: CEO

Address: 21410 N. 19th Ave., Suite 220
Phoenix, AZ 85027

Company Response Number: RUCO 6.04

- Q. Benefits to the Existing Customers – On page 4, line 16, of Mr. Bradford's testimony he describes seven techniques to reduce water loss. Admit or Deny Global Water cannot perform these same techniques to reduce water loss? If admit please explain why Global Water cannot perform these same techniques to reduce water loss?
- A. Again, Willow Valley has implemented many of these specific water loss provision measures, including replacing all customer meters with advanced meters and an AMI system. For additional information regarding Global Water's water loss efforts, please see Global Water's most recent water loss report, available at this link: <http://images.edocket.azcc.gov/docketpdf/0000162192.pdf>

Global believes that replacement of substantial portions of the distribution system will be necessary to achieve significant reductions in water loss. Regarding Global's ability to complete a distribution system replacement program, please see the response to RUCO 6.02 and Mr. Fleming's Rebuttal Testimony.